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The International Symposium on Derivatives and Risk Management

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THE INTERNATIONAL SYMPOSIUM ON DERIVATIVES AND RISK MANAGEMENT

February 24, 2000

*Day One of a Conference Sponsored by the Fordham Institute on Law and Financial Services, Focusing on Litigation and Derivatives**

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* The conference herein was held at the Fordham University School of Law on February 24, 2000 as part of a two-day conference on derivatives and risk management. It has been edited to remove the minor cadences of speech that appear awkward in writing, and to identify sources referred to by the speakers.

INTRODUCTORY REMARKS: PERSPECTIVE ON DERIVATIVES AND RISK MANAGEMENT

PROFESSOR FELSENFELD:* Good morning. On behalf of the Institute on Law and Financial Services, the sponsor of this conference, I want to extend the welcome of the Law School and the Institute to you this morning. This is our third symposium on the subject of derivatives, and I think it is now time to call it the Third Annual Symposium on the subject of derivatives. We anticipate that this will be a regular event at the Law School. I am pleased to see you here today, and I hope to see you here in the future.

We have sensed a growing interest in the subject of derivatives over the years, and for that reason we have what I think you will find to be a very exciting program over the next two days. It is appropriate that the program exists. It is appropriate that you are here. It is appropriate that the interest is growing. Trade in derivatives has been increasing at a very rapid rate in recent years, and indeed even in recent months. Bank derivatives activities alone, I learned, increased $2.7 trillion in the third quarter of 1999 to a record $35 trillion. We are talking about a lot of money in this industry.

With trade in derivatives comes, of course, risk. Risk is unavoidable, and that is what this symposium is all about. The more the volume increases, in all probability, the greater the opportunity for risk. We see this in part because the derivatives market is, so far, an immature one. It needs probably a greater definition to give us more of a sense of what we are dealing with and who is dealing with it, because even today we can see various kinds of transactions that probably should be approached in different ways. There are transactions between the institutions: the banks, the brokerage activities, the insurance companies, and their customers who want to invest more in derivative obligations. On the other hand, we also see the trading of derivatives by these institutions for themselves—banks for themselves and insurance

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companies for themselves, as well as companies and corporations trading for their own purposes—to hedge risk, perhaps to increase risk, and to engage in the opportunity for greater profit, all going on at the same time.

While we deal with these different methods of trading in derivatives, there is actually very little definition of a derivative. Everybody knows that a derivative is a financial product that is based upon something else. But when we are pressed into saying that, and we recognize the look of confusion or bafflement in the person to whom we give that definition, where do we go from there? How do we tie it down so that we can deal with it? Is it, for example, the major daily trade of financial institutions in currencies around the world—trade that extends in the trillions of dollars per day in the purchase and sale of currencies? Currencies are traditional derivatives. Is this something that ought to be dealt with? Is it something that ought to be measured as a derivative? Is it something that ought to be regulated?

Put that along with the speed with which these transactions are being processed—the speed or the regularity. Those who want to trade in derivatives can forget about going to sleep. Sleep is no longer a possibility, because this is a twenty-four-hour-a-day system around the world. If you decide to get what has been your traditional hours of sleep, you will miss something. In missing something, the consequences can be expensive.

The speed with which transactions occur and their international scope is well reflected in the insolvency and failure of Barings Bank, one of the major international institutions. One of their traders, as you know, was perhaps a little too over-extended, perhaps a little careless, perhaps a little over-ambitious, perhaps acting on the orders of Barings—one doesn't know—in Singapore, and the consequences were felt immediately in London. This is the kind of thing that can and does easily happen.

While we talk about the possible regulation of the derivatives market, one of the other considerations we have is that the nature of the market, its transactions, the nature of the transactions, and their growing complexity are probably growing faster than the ability to regulate. If you have a group of smart people sitting down in Washington, in New York, in London, or in Basel, working out a regulatory structure for perceived problems, the problems are going to get worse before the regulatory structure hits the press and can be commented upon. How do we deal with this? One doesn't know.

Conferences like this one are an effort to address the problems and see what we can do about them. We hope to address the problems in various ways. We will see what programs have developed. We have people here who are aware of what is going on in Washington and around the world and who are prepared to discuss it. We will have a major segment dealing with the lawsuits that have developed. How are lawyers handling the problems? How do we decide whether a loss should be imposed in these transactions? This will be addressed by a group of prominent lawyers who are deeply involved in derivatives transactions. This will then be commented upon by judges who will be here, who will hear the lawyers, who will hear their presentations, and will say how this looks to them from the judicial side, and we will learn from them.

So I look forward to this program. I hope you will learn from it. Here, to monitor and control the program is the person who created it, Alan Rechtschaffen. Alan is an Adjunct Professor here at the Fordham Law School; he teaches a course in derivatives. He is also in the real world, out in the world of trading, dealing in derivative products. Alan, the floor is yours.

PROFESSOR RECHTSCHAFFEN:** Good morning. I want to thank Carl and his Institute for bringing the Risk Management and Derivatives Symposium 2000 to Fordham Law School.

You have already heard a lot about derivatives from Carl. Three years ago, this would have been called the "derivatives conference," since the industry was all about derivatives. I think that has changed to a certain extent; this is now more of a risk management conference. We have litigators here who are going to talk about where the liability lies for derivatives trading, derivatives sales practices. But at the end of the day, if you look at these cases we will discuss, and you study the complaints, you will see that people say, "Look, I lost money; why did I lose money?"

**Adjunct Professor, Fordham University School of Law; Chairman and Founder, Fordham Derivatives and Risk Management Symposium.

Some of these problems could have been avoided with appropriate risk management techniques.

So, for the rest of the day at least, I am going to call this the "Derivatives and Risk Management Symposium," because risk management is a part of the picture now. People are looking at the stories of Barings, Procter & Gamble and Bankers Trust, and all the other exciting headlines, and saying, "What do we do now?" The regulators are saying that. Shareholders are saying that.

There is a quote which I got from a book on derivatives[1] written by a new friend of mine, Bob McLaughlin, who is here. Bob has told me that he has had to remain in hiding for the last two years because this book took so long to compile. Unfortunately, we all know how fast this industry is moving. He will have to go into hiding for the next two years and rewrite the book. This is a quote I read in his derivatives publication, and I wanted to read it to you: "Panics, in some cases have their uses; they produce as much good as hurt. Their duration is always short; the mind soon grows through them and acquires a firmer habit than before." The firmer habit? Risk management. This was taken from Bob's book, but I want you to know that this was originally said in 1776 in a book by a man named Thomas Paine in his writings on *Common Sense*. A lot of what we are going to talk about here is common sense.

What do we do? We know the problems. We have derivatives. We know that it is a twenty-four-hour-a-day trading environment. We know that there are a great deal of lawsuits out there, and we know that directors and officers are nervous about these lawsuits. We also know that certain states are now permitting new investments for insurance companies, so we think about Orange County. All of the headlines have become the prologue to the risk management environment, the risk management landscape in which we live today.

With us today are a number of people from the Office of the Superintendent of Insurance of the State of New York. We have asked them to come here, and they have enthusiastically decided to

1. ROBERT M. MCLAUGHLIN, OVER-THE-COUNTER DERIVATIVE PRODUCTS—A GUIDE TO BUSINESS AND LEGAL RISK MANAGEMENT AND DOCUMENTATION (1998).

participate, because New York is changing its laws. It has changed its legislation on permissible investments by insurance companies. The landscape is changing. The participants are growing. As such, we have to get a firmer habit—risk management practices that will control the use of derivatives.

This symposium focuses on the risks and legal ramifications associated with capital markets trading—not just derivatives, but anything involving the capital markets. But the most volatile of these capital market trading products are the derivatives. They are highly leveraged, generally. They are not inherently value-driven, but their leverage makes them incredibly volatile, and we have to figure out how to rein in the risk of using these derivative products.

As Professor Felsenfeld alluded to, derivatives, and all capital market trading activities, are used for one of two purposes: managing risk or increasing yield. Banks and brokerage firms want to sell derivatives to facilitate this two-pronged process with their customers or their counterparties. Hedge fund failures, corporate headlines, and the "rogue" trader scandals have all alerted directors and officers to the need of having prudent risk management practices at their firms. Directors, officers, and regulators want to keep the funds out of the headlines. What I want to do today is talk to you about some of the guidelines and the attention that we can pay to putting into force these firmer habits that Thomas Paine talked about in 1776 to control capital market trading activities.

Now, if you were listening earlier, you may be wondering, "Why did I bother to come here? I could have spent the day somewhere else, and I don't need to hear the risk management lecture." But what is interesting about the evolution of the laws governing risk management, and where the regulators can come in, is that these failures, these headlines and scandals and rogue traders, all could have been avoided if—well, I shouldn't say all of them—a lot of them could have been avoided, had there been appropriate risk management tools in place.

Regulators and shareholders use operational risk techniques to describe prudent behavior and to encourage the implementation of risk management strategies. Susan Phillips was one of our first speakers at this symposium three years ago. She was a member of the Board of Governors of the Federal Reserve System, and is now the Dean of the George Washington University School of Business. She is a good friend of mine. She and I were talking about the role of risk management in the regulatory process. She observed that the regulatory structures of the future are much more likely to emphasize trading parameters, stress testing, process, and internal controls.

This emphasis on process and controls will have a profound effect on director and officer liability for corporations and successful theories of recovery for litigators. Shareholders and regulators increasingly expect that those responsible for the capital markets trading activity and derivatives trading will make prudent decisions in managing firm liability. Now, if you look at the case law—and there isn't much out there—and the regulatory guidelines that are around or the Basel documents, there is a great deal of uncertainty as to what senior management and board members must do to limit their liability, and what a firm can do so that a party who has been hurt cannot get into their pockets.

The answer, I think—and this is why I am so enthusiastic about the next couple of days—is education and implementation of best practices. Consider this symposium the first step, because everybody here should go back to their governmental agencies, to their corporations, to their law firms, and understand that education will have a huge role in the risk management and derivatives marketplace over the next five years. We are here at this symposium taking the important step of beginning the education process. Regulators focus on encouraging responsible risk management. By encouraging education in the area of operational risk, regulators and shareholders can encourage best practices.

Firms on the London Stock Exchange are now required to issue statements explaining whether or not they are in compliance with standards of best practices for risk management. Directors and officers will sometimes have no idea about their company's derivatives trading activity and their capital markets activity. There needs to be an education process, one similar to this symposium, but tailored to individual entities. In our audience, we have directors and officers of public corporations and financial institutions, legislators and regulators, and representatives from the Federal Reserve, the Office of the Comptroller of the

Currency, the Securities and Exchange Commission, and the Office of the Superintendent of Insurance of the State of New York, all of whom are here because they recognize the role that education plays in managing risk.

You are probably familiar with the business judgment rule, which essentially says that a court will not look into a decision made by a director because we want to let directors have the ability to make decisions without the court inquiring into the correctness of that decision. Directors can make mistakes, but the caveat is that they can make mistakes so long as their decisions are informed. By making informed decisions, you can limit your liability. In limiting that liability, education will play a key role. Regulatory structures emphasizing education, stress testing and parameters, and the successful principles of risk management will not only limit liability but will also limit the headlines, and the lawsuits.

Fordham University School of Law has played an instrumental part in the evolution of education in the field of risk management. For four years we have offered a course that should have originally been called "Derivatives Trading" and now should be called "Risk Management and Derivatives Trading." It is a vital step in Fordham's evolution that the important regulators are using our educational forum as the venue for their education and for the exchange of ideas. In this exchange of ideas, I encourage people to talk to each other and to network at this symposium.

Professor Felsenfeld and I were in the hallway and we met one of the top regulators who is here today. He said, "I am looking forward to hearing from the others who are here on derivatives and risk management." The regulators want to hear from you. The regulators want to hear from the litigators. They want to hear what the litigators are looking at because they have to form policy. The litigators are paid—and they make more money if they win their cases—to figure out where people went wrong and what caused the problems.

So our symposium focuses on four areas, and throughout the symposium each of the subjects being discussed will fall into one of four areas:

- First, utilization: the use of derivatives, the end-users, and where the end-users stand right now in terms of using derivatives products in capital markets trading.

• Second, litigation: the case law, including the recovery, when derivatives or derivatives trading or sales practices lead to lawsuits.

• The third area which will be discussed is regulation, the reaction of market regulators to utilization and litigation. In the wake of the repeal of the Glass-Steagall Act,[2] we have insurance regulators and banking regulators discussing the same subject: how do we regulate this marketplace; how do we regulate the firmer habit, and force directors and officers to implement the firmer habit at their firms; how do we force risk management?

• The fourth area is education. The education process cannot end with the end of this symposium. The education process must continue onward.

I started out by saying that this is the perfect starting place for looking at the derivatives marketplace and over-the-counter derivatives. The advent of new regulations and new marketplaces is a start. But we have to continue to become informed, continue to come to symposia, continue to go online and find new information, and continue to supplement it with books like Bob's and other books and articles on what is happening.

Two of my students have offered to help me put together an open exchange of educational resources on the Internet.[3] You have some information about that. This open exchange of educational resources is really where the market has to head. We have to explain to people where the risk lies in capital markets trading activities. These risks rise to the level of the chairman, the board of directors, and every senior officer, for they will be held responsible by regulators and shareholders.

I have asked a couple of people to help me with this symposium process over the next two days, one of whom is a former student of mine. It is interesting to be able to call Carolyn Jackson a former student because she has vast experience in the area of derivatives and risk management. In fact, 1981 was when

2. The Glass-Steagall Act is the name commonly used to refer to §§ 16, 20, 21, 32 of the Banking Act of 1933, 12 U.S.C. §§ 24, 78, and 377-378 (1994 & Supp. II 1997). Recently, the Glass-Steagall Act was constructively repealed by the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101, 113 Stat. 1338 (1999).

3. Risk and Derivatives Consulting Board, Inc., *Riskandderivatives.com,* at http://www.riskandderivatives.com (last visited May 15, 2000).

the first big derivatives transaction took place, the 1981 swap transaction between the World Bank and the IMF. A year later, Carolyn Jackson, who is a Vice-Chair of this Symposium, was heading the derivatives trading desk for fixed-income dollar-based securities at The Chase Manhattan Bank. Her experience has evolved with the industry, culminating in her service as the Executive Director of ISDA, the International Swaps and Derivatives Association, from 1995 to 1997. I am very proud that she is a former student of mine and is willing to come here today to tell you a little bit about where the industry is headed, where the utilization is going, and what happens when things go wrong.

We will begin with Carolyn Jackson, who is a good friend, a very important person in the industry, and my running partner. I am going to ask Carolyn to explain what the role of ISDA is in the marketplace, how it evolved, and who the members are. I think it might be helpful as a background to Ruth Ainslie's talk. So if I could, I would ask you, Carolyn, to speak a little bit about ISDA and what the ISDA documentation looks like.

By the way, Carolyn, in addition to being a former student, has also served as a co-faculty member for my class, so I know that she is well versed in this area, and this is not as off-the-cuff as it sounds. Carolyn, if you don't mind, please come up and take over the podium.

CAROLYN H. JACKSON:*** Good morning. ISDA was formed in 1985. I don't know if you all know that, because now we take it for granted that there is standard swap documentation. But back in the early days—as Alan mentioned, the first big swap transaction was done in 1981—almost everybody totally reinvented the wheel when it came to documentation. Even after people did a trade and went to do the next trade, instead of getting the document out and saying "oh well, three-month LIBOR, six-month LIBOR, Swiss francs, deutsche marks," they started from scratch on what was generally a thirty five page document.

Even over things such as LIBOR, the London Inter Bank Offer Rate, the standard floating rate term, there was huge debate. If I were at Chase, I would say, "Oh, it should be Chase LIBOR."

*** Former Executive Director, International Swaps and Derivatives Association, Inc.; J.D, Fordham University School of Law, 2000.

If somebody were at Citibank, he or she would say, "Oh, it should be Citibank LIBOR." And so, needless to say, there was tons and tons of time wasted with people arguing back and forth about the most minute terms.

Following the Salomon Brothers deal, a group of industry people began to talk to each other informally, saying, "Gee, wouldn't it be really nice if we could just standardize the terminology?" That is actually how the trade association began. The document was yet a dream. People just said, "Let's understand what it basically means, a 'business day?' What does it mean, a 'floating rate?' What happens if LIBOR doesn't become available? Where do you go for a rate? What newspaper do you go to?"

So, in 1985, ISDA was created. The first thing the group put out was a Standard Code of Language. For example, if you were Chase, they would have their own document and attach the Code, and that clarified all the legal terms and all the language. And then, with time, it evolved to where people wanted to go one step forward and actually standardize the document.

When ISDA was first formed, there were about ten members. Now I think there are roughly 450. The way ISDA started was really totally around documentation. But, as Alan alluded to, the industry has greatly evolved. First, documentation was one of the hottest issues. Then, new trading and risk management became a hot issue; then eventually a lot of policy issues, especially as the industry became more and more the focus of the press and regulatory agencies.

ISDA exists with about twenty working committees all around the world. When I was Executive Director in 1995 and 1996, we opened a London office. I believe there is going to be an office in Tokyo in April, and in Singapore next year. Initially people saw ISDA as a U.S.-based organization, and the reality is that more of its members are from Europe. It has definitely become the "I" in international.

ISDA runs through various committees; for example, when things heated up about the CFTC reauthorization and the influence of the Commodity Exchange Act over the derivatives industry, ISDA formed a working committee to try to address those issues and decide what the policy of the industry should be.

And similarly, with the Basel proposals, the capital requirements, a group of ISDA members would get together and write an industry response detailing the appropriate amount of capital to be set aside for various capital and market risks.

Likewise, essentially around 1994, with all the derivatives litigation and the concern about suitability issues, the industry worked together with other trade associations to put out a policy statement called "Principles and Practices," which basically clarified that derivatives transactions were done on an arm's-length basis.

I have the ISDA expert with me now, and so I would like to take this opportunity to introduce Ruth Ainslie. Ruth has a very interesting background because she has been a lawyer at Bankers Trust for the past seventeen years and just joined ISDA this January. She has a very responsible position, in terms of being the Senior Director for Policy of the Americas, as well as in charge of all the press relations. I can remember from my days at ISDA, the constant media calls, especially when something hot was going on in Washington. So it is a very, very important position, and it is very interesting to see somebody go from the legal side to the business side, since I am doing the reverse.

My main purpose right now is to introduce someone I have had the pleasure of working with, Ruth Ainslie, who is the ISDA Senior Director for Policy of the Americas. With that, I would like to turn it over to Ruth and give her a warm welcome.

INDUSTRY PERSPECTIVE

RUTH W. AINSLIE:* ISDA is very pleased to be at Fordham today and to work with Carolyn, and we would, of course, like to thank Carolyn, who, as she told you, is IDSA's former Executive Director. I am going to talk today about what swaps are, how they are documented, and the regulatory environment around swaps.

You may have seen this or heard this particular bank advertisement on the radio: "Our bank has no junk bonds; our bank has no derivatives." That ad is supposed to entice you to deposit money with that bank. From our perspective, we probably agree with them that junk bonds may be a very risky investment for a bank. It is a credit concern, and it may not be appropriate. But we would like to talk further about a bank investing in derivatives.

Let's talk about risk activity. Which entails more risk, hedging or not hedging? Banks tend to have liabilities on the floating-rate side. They do their funding and their borrowing through floating-rate instruments, like three-month CDs. On the asset side, they generally have more fixed-rate instruments. Not hedging this type of interest rate mismatch is probably very risky for most banks.

Who faces the types of risk that OTC derivatives address? First, financial institutions. We just talked about banks, but all forms of financial institutions face many different kinds of rate risks; and the more global an institution is, the larger the variety of risks faced. Second, corporations are exposed to interest rate risks and currency risks as soon as they cross a border and have income coming in another country or payrolls going out to another country. They may also have commodity risk, depending on the nature of their business. Third, governmental entities are subject to risks as well. Large governments have larger risks, but small governments have lots of risk too, as do small agencies.

The types of risk that OTC derivatives address are interest

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* Senior Director for Policy in the Americas and Media Relations, International Swaps and Derivatives Association. Ms. Ainslie collaborated with Rick Grove, Chief Executive Officer of the ISDA, in preparing her presentation.

rate, currency, equity, commodity, and credit risks. All of these are fairly self-explanatory in concept. In detail they can be really complicated.

Diagram 1: Interest Rate Swap

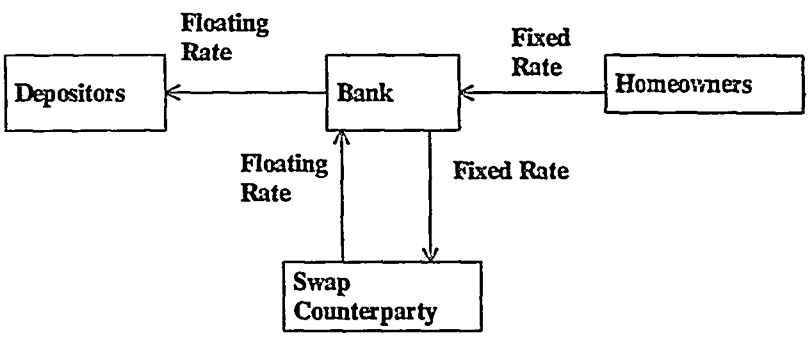
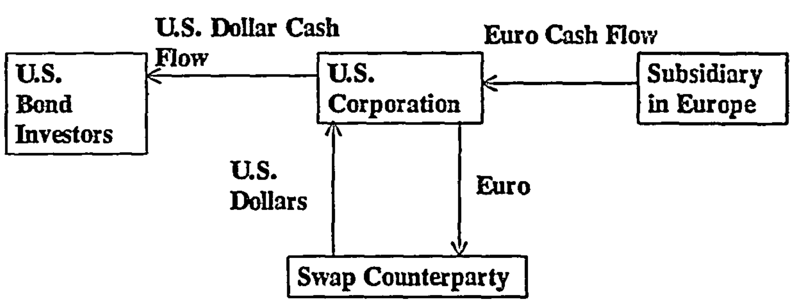


Diagram 1 shows how an interest rate swap works. A bank is paying a floating rate to its depositors. It is receiving a fixed rate from homeowners, like us. What the bank can easily do to manage the fact that it is receiving a different rate than it is paying out, is go to a swap counterparty, and swap the fixed amount it receives from the homeowner for the floating amount it needs to pay to the depositor. It has then matched those risks.

Diagram 2: Currency Swap



We can talk about derivatives as risk management tools in terms of currencies as well, as seen in Diagram 2. A very typical situation is a U.S. corporation that has a subsidiary in Europe and has revenues from Europe. The corporation is going to have Euro cash flow coming in. Now, in the United States, it has to pay its bondholders, and servicing its bondholders is always going to be in dollars. So the corporation will swap those European revenues with a swap counterparty, and get dollars. The dollars then go to the bondholders and the corporation has matched those risks.

What are the principal benefits of OTC derivatives to users—users being corporations, governments, smaller banks—entities that are not dealers in derivatives? They can hedge the risks that they would otherwise not be very well equipped to manage. Hedging risk is not their business. Hedging risk is not what they do. McDonald's sells burgers; GM sells cars. They do not really hedge interest rate risks in the same way that they sell burgers or sell cars. But engaging in these kinds of transactions, entering into derivatives, is in fact a way for them to manage these kinds of risks. And it gives them far more time to focus on their principal businesses, which is what we want them to do in terms of the economics of the United States. It is much better for the economy, in general, for entities to focus on what they do well—on what their specialties are.

What are the principal characteristics of OTC derivatives? The first one, a very important one that we will discuss further when we talk about regulatory issues, is that they are bilateral in nature. Two parties, called counterparties, transact with each other in one of the derivative transactions that we have described: interest rate, equity, commodity, credit, or currency-based transactions.

Counterparties are generally institutions. For the most part, derivatives are transacted between very sophisticated parties—banks, corporations, governmental agencies. Generally, there are two-way credit exposures: I pay you fixed, you pay me floating. There are some exceptions. There are some option transactions in which, once the initial payment has been made, there is no risk to that payor anymore in terms of what he has to pay, just in what he has to receive. But generally, derivatives are two-way credit exposure transactions, very different from a bank loan. A bank lends money to a company and waits to be paid back. Derivatives transactions are different. There are two-way flows. The economic terms are a contractual agreement between two counterparties to exchange cash flows on a notional principal amount for a stated period of time.

The notional principal amount is something that we should talk about. If you have a $300 million swap transaction, the notional principal is $300 million. $300 million is not at risk. Let's say there are semi-annual payments and they are triggered into two different kinds of interest rates—whether they are Treasury-based or LIBOR-based or some other kind of interest rate base, prime base—and on those days Party *A* and Party *B* pay each other an interest amount that is calculated against the notional amount. But it is an interest amount. So the $300 million does not go from one party to the other party; that is not exchanged. The cash flow is exchanged, and these payments are linked in some way to the value of some other market price or instrument—like prime, like LIBOR. The maturity just means how long this contract is outstanding.

There are periodic cash flow payments, so the notional number of global outstanding derivative transactions, which is the number that gives people some pause—an $81 trillion market per the Bank for International Settlements' June 1999 survey,[1] is a huge number. That is not the number at risk.

It is broken up as follows:

- Foreign exchange represents almost $15 trillion. That number is going down. Partially it is going down because there used to be many currencies in Europe and now there is one EU currency. So, a lot of transactions that used to go on between the mark and the franc do not happen anymore.
- Interest rates represent approximately $54 trillion. This number is increasing.
- Equities represent about $1.5 trillion. Although they are increasing dramatically, they are still a very small part of the market.
- Commodities represent $0.4 trillion.
- And "Other," like credit, is a very small, but very growing, $10.5 trillion.

1. Press Release, Bank for International Settlements, The Global OTC Derivatives Market at End-June 1999 (November 1999), available at http://www.bis.org (last visited Nov. 15, 2000).

The total is over $81 trillion. Credit derivatives are the fastest growing segment, in terms of notional amount. On a market value basis, if you were to take every one of those transactions that is out there and say, "Okay, close that transaction out today," the value that would be exchanged on that day would be $2.6 trillion. That is a significantly lower number than the $81 trillion.

Now, if we consider netting, in which if I owe you $100 and you owe me $102, because the values have changed, the $2 differential would be paid, nothing else. So instead of my paying $100 and your paying $102, only $2 is exchanged. That brings the aggregate value of all these transactions down to $1.1 trillion.

What we haven't even factored in is credit support or collateral. If you add collateral, which again brings down the risk amount, you are under $1 trillion of global risk exposure on outstanding OTC derivatives transactions. So if you look at the market, you see that it is a huge market; it is a vast market, but the amount at risk is much less than the notional amount. That is really a pretty important piece of what this market is all about.

I am going to turn now to the documentation piece of this market. Derivatives are less than twenty years old, which I am sure Carolyn or someone prior to me has said. The documentation, however, which is of course much less than twenty years old, has become a global industry standard. The documents—generally ISDA documents, but there are some others as well—are fairly well accepted just about everywhere in the world. With the growth of emerging markets transactions, they have become accepted in emerging market countries by emerging market counterparties.

These documents provide the opportunity (i) to tailor credit terms between the counterparties after evaluating the creditworthiness of each party; (ii) to make sure that the economic terms of each particular transaction are set forth very accurately for that transaction; and (iii) to include credit support terms based on the creditworthiness or the market conditions or some other reason why having collateral would help you manage your risk. Those terms can be varied on a changing and evolving basis as is necessary for the transaction.

The Master Agreement itself is an interesting concept, and the first of its nature. It is a single bilateral contract between two counterparties; it contains credit terms as negotiated between the counterparties, and it governs multiple transactions, all of which form a single agreement. You could have under a single ISDA Master Agreement one transaction or 406 transactions. In each case, you would be talking about a single agreement.

Under that agreement there are certain provisions that are very standard. You have the option in the agreement to require payment netting. Payment netting is the example I gave you before: on the 30th of June I owe you $100 and you owe me $102, and we only exchange the $2. So for a particular transaction on a particular day we exchange a net amount. This is operationally intensive. Institutions have to be able to handle this and recognize it on computer systems, but it is a very good way to manage risk. This risk is called "settlement risk." If I were to pay you the $100 and you were never to pay me the $102, I am either out $100 or $202, depending on how you count. Settlement risk is a very big risk.

The other form of netting, and the one which the Agreement originally targeted, is close-out netting. In the event that there were an event of default, the counterparty who did not default has the option to close out every single transaction covered by the Master Agreement on a net basis, calculating what is owed under each transaction on a net basis and then netting all of those net amounts. Finally, one single net payment is owed. You could start out with transactions worth, say, $500 million on each side, and the net payment owed at the end—and it could be owed to either party—could be $60,000. That is not an irrational result here. So that is a very important concept that the agreement contemplates.

Events of default are triggers to alert the other party that something has gone wrong. They are related to the condition or the actions of counterparties. Conditions include whether the counterparty is properly incorporated, has it paid its taxes, and is it authorized to enter into and perform the transactions under the agreement in accordance with the terms of those transactions. By actions I mean: has the counterparty defaulted on debt to other parties, or has the counterparty failed to provide financial statements when asked to? These are defaults over which the counterparty has some kind of control. As a result, if such a default happens, the other party then has the option to close out and liquidate, but it must close out and liquidate all but not less than all of the transactions because it is a single agreement.

Termination events are events that are beyond the control of the counterparty—an illegality, a supervening illegality; a law is changed so that it is no longer legal for the counterparty to enter into or to perform a particular contract; credit event upon merger, two entities merge and the rules around what they can do after that change. The difference between a termination event and an event of default, or how it is treated in the document, is that in termination events you sometimes just get rid of the offending transactions. Let's say certain transactions are now subject to tax but others are not. You can close out just those transactions that are subject to tax; you do not have to close out all but not less than all. That also makes a big difference.

Also, the methodology for close-out changes. If you have an event of default, the close-out calculation is highly documented. There are two methods. First is market quotation; where you go in a specified way to market sources, get prices for transactions, and then go through the methodology to get to what is the price to close out this transaction. This could be done by going to the mid-market, by throwing out the high and the low—or any number of ways. And, by the way, getting to the price can sometimes be fairly complex. Loss is the other methodology. It is one that is growing in its acceptance. Loss is replacement cost. If I were to get rid of this transaction by replacing it, what would it cost?

One of the most important parts of the document is the schedule to the document. The schedule to the document allows flexibility. Parties can choose which events of default they want to apply, whether they want netting to apply, whether they want to bring in collateral, certain time periods, and certain other kinds of agreements between them. These are always based on the relative credit positions of the two counterparties or the relative status of the two counterparties.

Obviously, banks are free to do an awful lot of things in financial markets. Certain other kinds of entities may not be so authorized. Insurance companies may be more constrained to enter into certain kinds of transactions than banks. Corporations may have certain kinds of internal rules, as opposed to regulations, that surround what they can do. So the schedule gives a great deal of flexibility.

Interestingly, schedules can be very difficult to negotiate. About ten years ago, when I was at Bankers Trust, I negotiated the Bankers Trust/Chemical ISDA Agreement. That was the "old" Chemical, before its mergers. It took two years to negotiate the agreement. We are talking about two institutions that were very similar in a much simpler time, and that was a very typical time period.

Negotiation has advanced a great deal. A lot of issues that we thought might be issues are not issues, and new issues have come up. Many things have changed a great deal. To give you a sense of how prevalent the ISDA document is, Bankers Trust had, as of last year, 4,000 ISDAs outstanding. It merged with Deutsche Bank, which had 6,000 ISDAs outstanding. So this is a very, very widely used document.

The Confirmation is the key to each transaction. It sets forth the economic terms. If you have a series of transactions under an agreement, you have a Confirmation for each one. Again, taken together with the Master Agreement, it forms a single agreement. The economic terms that have to be included are the notional amount, the maturity, the currency, the price source, the product type, and other things that would be critical to dealing with each other through the course of one of these transactions.

Swap transactions have varying lengths. A foreign exchange spot transaction is generally two days. It is very common now to have ten-year swap transactions. If you are going to enter into a transaction that is going to last for ten years, you are going to make sure that you have tied up most of the loose ends because it is much harder to renegotiate when one entity is in bad shape later on.

The representative products that can be covered by these kinds of Master Agreements include: interest rate swaps, caps, collars, floors, and options; currency swaps and other FX transactions; equity swaps and options; credit default swaps, forwards, and options; commodity forwards and options; energy derivatives; bullion spot forward swaps and options; and all kinds of governmental bond transactions.

Through the years, ISDA has created definition booklets. These booklets give you a great deal of market knowledge about where the price sources are, how the price sources work, and they also give you a common language for a specific kind of transaction. The commodity definition booklet allows parties to know they are talking about the same thing because the defined terms explain to them that if you are talking about a particular kind of transaction, I am talking about the same one if I put it under the same terms.

Some of these definitional books are self-evolving. The 1998 FX and Currency Option Definitions booklet permits rate changes. The booklet was completed and published in 1998, and deals with a lot of emerging markets issues. Emerging markets are evolving markets, and because they are evolving markets, things change all the time, including rate sources, rate methodologies, what the governmental bond structure is. So that is a flexible definition booklet. It has an annex that can be changed. Other definition booklets, which are set for a time period, get reviewed and revised from time to time.

I think we will turn now to the Credit Support Annexes. The use of collateral to support documents is growing incredibly quickly. There are a variety of reasons for requiring collateral.

First, is there a credit standard for collateral? If you are dealing with someone from a financial institution perspective, you are dealing with a company whose financials you are not completely comfortable with, either because they are not doing well or because they are in a circumstance, like a hedge fund, where their earnings are extremely volatile. They could have this kind [indicating extreme peaks and valleys] of income stream at any point. You may wish to have collateral pledged to support the obligations between you.

In addition, there could be market reasons for having collateral pledged. The transactions could be in markets that are very, very volatile, and you would want to make sure that, notwithstanding what happens to the underlying rates that are part of the transaction, you still have a comfort and security level that the obligations will be met on a timely basis. The ISDA Credit Support Annex, which is something that is always being reviewed and revised, and is actually being revised right now—ISDA has done an enormous amount of work with collateral, different kinds of collateral, different jurisdictions—supports many types of collateral.

Until very recently, the safest way to make sure you had secured something was to use some kind of U.S. Treasury or U.S. cash. Now, the reason had as much to do with how wonderful U.S. Treasuries and cash were as that the legal system supported it. If you gave collateral in a particular way, you would be able to realize the benefit of it at the right time.

Every single type of collateral is subject to its own local legal system. In order to be confident that the collateral given can be used in the way you want to use it, you have to be assured that as a legal matter that is true as well. We will talk more later about the efforts that have been made to make sure that that is true.

The mechanics for posting and managing collateral, interestingly, have become an entire industry. Collateral management is a very important part of risk management in major institutions. It is supported by practitioners who are very high-level, well-educated, and valued people within institutions. It is not a clerical position. Collateral management is risk management, like credit risk management or market risk management. And as more and more collateral is pledged, and is pledged more and more on a global basis, collateral management has become incredibly important.

Going back to the legal opinions, there has been a huge initiative on the part of ISDA and other industry organizations to obtain opinions supporting the documents. The opinions for the Master Agreement have been opinions on the enforceability of the netting, primarily the close-out netting that we talked about earlier.

Payment netting, incidentally, is a contractual agreement between two parties, and no one has ever found a single jurisdiction where that is unenforceable, since it is just two parties agreeing to do it. Now, netting after default can be subject to all kinds of local regimes, specifically insolvency laws, because as soon as one of the parties becomes insolvent, that party is now subject to a court or a referee or a trustee in every single jurisdiction in the world.

So the question you ask is, "If my counterparty becomes insolvent, will I be able to close out this transaction and do it in accordance with the terms, and obtain the value that is owed to me?" And another question may be, "Will I be able to enforce it on a timely basis?"—because you may be okay with it if you know it is just going to be held up for a while but you will get it back. But these issues have been very complex to think about and to resolve.

ISDA now has legal opinions in thirty-four jurisdictions. What is important to realize is in quite a few of those jurisdictions, lobbying by ISDA, by local regulators from our country and some of the other countries, by industry groups, by individual institutions, has caused an enormous amount of legislative change. There has been an enormous amount of legislative change in this country to ensure that the environment for netting is secure.

Those initiatives are still going on—they are going on in Latin America, they are going on in Eastern Europe, they are going on in the Caribbean—in order to ensure that the documentation will protect the transacting parties in the way that it is intended to.

Now, why would you net? First, you could net for credit reasons, because you know that would give comfort that you would be able to realize on your value, and that you would not lose money. Second, you could net for capital reduction reasons. The Bank for International Settlements ("BIS") allows institutions to look at their exposure on a net basis if they, BIS, have met a certain number of criteria including; looking in the jurisdiction where both counterparties are and where all the transactions are, and at the laws, and obtaining a recent legal opinion on the fact that you will be able to realize it. This makes a big difference in the capital funding for banks. In other institutions, it is moving as well to investment banks. Third, you could net for financial reporting. You may also net balance sheet items related to derivatives if you are certain about enforceability and you can determine net closeout amounts.

The standards are different for all three, but they are there. Annual updates are required by the BIS, so each of these opinions is updated annually to ensure that nothing has changed to make them less enforceable. Collateral is a similar issue. So far there is no capital requirement for collateral, but we have now obtained at ISDA, twelve opinions in twelve jurisdictions, fifteen more underway, and annual updating will commence in 2002.

We turn now to the regulatory environment. The difficulty here is that these are new products in new jurisdictions and new structures and they do not fit squarely into old rules. As we have discussed, derivatives are really pretty new in the structure of financial products and they are evolving quickly. They are not the simple interest rate product, the simple currency swap product, or the simple foreign exchange transactions that they once were.

In the United States, there has been pretty much a status quo on the regulatory side. The rights and obligations are pretty much governed by the contractual agreement. Parties can contract with each other to handle their own financial management in the way they wish. There is no specific regulation of OTC derivatives transactions. As a general matter, that is true.

It is unlike securities and futures. Under the securities laws and the commodities laws, participants in the securities markets and in the futures markets are subject to a great deal of regulation. They are subject to reporting requirements. There are penalties for not transacting exactly in accordance with the rules and regulations. This is more like bank loans. Although banks are regulated, the loans they make are not, and you do not need to get any regulator's permission in order to enter into a bank loan. Corporations do not need permission to obtain a bank loan.

What are the reasons for this lack of specific regulation? Well, policy concerns are not implicated in the same way. Investor protection is not deemed to be nearly as important a consideration when you are talking about derivatives. Generally, it is an institution-to-institution market. The securities laws are consumer protection statutes; they protect individuals. Institutions are not the target of consumer protection statutes. This was entirely an institutional market. It has become not entirely an institutional market; the nature of the institutions has changed, but it is still institution-to-institution for the most part, so we do not have the investor protection statutory scheme that we have in other products.

Price discovery is not the same kind of issue. Nobody goes to the currency swap to find out what the Euro is trading at; you go to the foreign exchange markets. Nobody goes to the interest rate swap market to find out what LIBOR is or what the prime rate is. So the price discovery mechanism is very different. If you are trading West Texas Intermediate or Brent Crude, you are not going to look at the swap to see what the price is.

For these reasons, and because of the incredible depth of the markets and the incredible liquidity of most of these markets—it is very difficult to fathom in fact the size of the Treasury market—manipulation is not as likely. It is very hard to corner the market in yen or dollars or Treasury bills. So for those policy reasons, historically there has not been the same kind of regulatory overlay.

In addition, the costs are very significant. Every time you put in a new legislative/regulatory initiative, it is costly to the government that does it. It is costly to the participants who have to manage it, and it is costly to the system, because it has a chilling effect on whether you do those kinds of transactions.

The third reason is the nature of the participants. The participants are ones who do not naturally need to be taken care of because they are supposed to be very sophisticated and they understand their markets.

The relationship between the Commodity Exchange Act (CEA),[2] which governs transactions in commodities, and the swaps market has been under discussion for a long time. In 1989, a Swaps Policy Statement was issued—this was the first one; swaps were very new then—saying that swaps should not be regulated as futures. The CFTC is concerned with futures. Futures are traded on exchanges. Trading a future off-exchange is illegal under the Commodity Exchange Act. If swaps are not futures, then they do not need to be regulated as though they are.

In the early 1990s, there was congressional action, and the Swaps Exemption[3] came into place, which gave rules around which you could enter into swaps and be sure that your swap would be a valid transaction neither void nor voidable. In 1998, the CFTC issued a Concept Release.[4] The Concept Release put immediate uncertainty for all swaps based on security prices. It led to other uncertainties as well. It raised questions about where the CFTC was heading in terms of the whole derivatives market. This became such a major issue that, in September, 1998, a congressional moratorium went into place to hold off on the

2. 7 U.S.C. §§ 1-25 (1994 & Supp. II 1995).
3. 17 C.F.R. § 35.1 (2000).
4. CFTC, Concept Release, Over-the-counter Derivatives, 63 Fed. Reg. 26,114 (May 12, 1998).

implementation of the Concept Release until such time as this could be reviewed.[5]

In 1999, a President's Working Group, which was composed of the Federal Reserve, the Treasury, the CFTC, and the SEC, issued their report.[6] In this report, which was unprecedented for its unanimous agreement, Chairman Greenspan, Chairman Levitt, Secretary Summers, and Chairman (by this point) Rainer of the CFTC agreed that legal certainty for the swaps markets under the CEA was something that had to be dealt with, that it was extremely important to address the issues of legal certainty so that the markets were not disrupted, and from the regulators' perspective as well, so that the markets did not go offshore. The Commodity Exchange Act could potentially provide regulation that is absent in virtually every other country in which commodities are transacted, and that would drive a great deal of U.S. business offshore if it became too onerous to do those kinds of transactions onshore.

Now let's talk about the regulation of institutions. Banks, security firms, and insurance firms are regulated because of the public policy interest in protecting depositors, account holders, and policyholders, and it is very important to prevent systemic risk. It is very important that the failure of one or more institution does not cause a domino effect and cause massive systemic risk.

Through regulation, supervision, and examination, there is a comfort level that this is less likely to happen. In this way, most of the dealers of OTC derivatives are in fact regulated, but not because they deal in derivatives. Other dealers in OTC derivatives are not regulated either, and that is because the public policy issues that are present in so many other products are not present in the derivatives market. Self-regulation has really been the way the market has developed. There has been a very strong development

5. *See* Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 § 760(a)(3), Pub. L. No. 105-277, 112 Stat. 2681 (prohibiting CFTC rulemaking proceedings, interpretation releases, and policy statements with respect to swaps and hybrid instruments until April 1, 1999).

6. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT (Nov. 1999).

of a risk management approach following the 1993 G-30 Report,[7] a global report investigating what derivatives are, how they work, and how we manage them.

There are some key elements to internal regulation. First, there should be sound corporate governance. Companies should establish parameters under which all their financial market transactions are undertaken.

Second are risk management procedures; establishment of independent procedures and systems to monitor adherence to these parameters. Interestingly, risk management has turned into a whole industry. There are credit risk professionals, market risk professionals, collateral management professionals, and now operations risk professionals. These are all different kinds of risks that can be managed and can make transacting in derivatives a safe, viable, and excellent tool for risk management.

The credit risk management side has to do with evaluating counterparties. It also has to do with evaluating countries and their structures and their instruments. The market risk side obviously has to do with markets, and that goes for countries and instruments as well, and the way in which markets evolve and develop and how they are regulated. The collateral management side is about what collateral you take, what are the processes, when do you pay it out, when do you take it back, how do you account for it, how do you record it, who values it, and who handles disputes. These are the kinds of issues that run through all of them.

Operations risk is concerned with what happens if there is a computer failure, or what happens if Citibank can't make a single payment tomorrow. What are your back-ups for that, how does that work, what is an error in a claim based on an operational risk, and what is really a credit issue that has not been managed?

Major institutions increasingly have put together policies and procedures that enable them to work better. When Carolyn referred to the Principles and Practices initiative that came out in 1995, which talked about arm's-length dealing between counterparties, there was a huge section on risk management and

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7. GLOBAL DERIVATIVES STUDY GROUP, GROUP OF THIRTY, DERIVATIVES: PRACTICES AND PRINCIPLES (July 1993).

what you could do to improve your risk management and how to make it more effective.

Basically, these are some of the major issues in the OTC markets, how you document them and how they are regulated. I would be happy to take any questions.

QUESTION: Are people starting to use the ISDA for repurchase agreements?

MS. AINSLIE: It is interesting you asked that. That is about the only two-way arrangement that is not typically put under an ISDA agreement. There are, as you probably know, standard agreements—the Bond Market Association (BMA) in the United States; Organizzazione Sammoarinese del lavora autonomo (OSLA) and International Securities Market Association (ISMA), outside of the United States. So far, repurchase agreements generally are not put under ISDAs. It is hard to do.

QUESTION [PROF. RECHTSCHAFFEN]: A number of the people who are here today are litigators. I wanted to ask you a question because you focused over and over again on the nature of the participants. My question really stems from successful claims in the area of derivatives and derivative trades when there is a loss. You, as a representative of ISDA, said numerous times, as did each of the participants, that this is a dealer's marketplace?

MS. AINSLIE: Generally, yes.

QUESTIONER: It is for the big people, it's not for the little people?

MS. AINSLIE: Generally.

QUESTIONER: Do you think as an attorney that it is prima facie evidence, on its face evidence, that a transaction is unsuitable for a non-institutional client or counterparty, even if it is an arm's-length transaction?

MS. AINSLIE: The swaps exemption of the Commodity Exchange Act has described and defined an eligible swap participant, and there are individuals included in that. A lot of this has to do with the combination of financial wherewithal, but also sophistication—knowing what you are doing and knowing what your risk is. So an eligible swap participant goes all the way from Citibank to an individual who has a certain net worth available for the transaction. So I think it is not a very simple question. Are there people who should be protected? Sure, but that is not even my opinion, that's everybody's opinion. But I think you have to look at the facts of each case.

Is that what you are asking? I mean, clearly, one of the primary goals of the Commodity Exchange Act, and a very good goal, was to punish fraudulent transactions, and people who manipulate markets. So if you are referring to counterparties for whom this is unsuitable, they should have remedies. They should have remedies if they are under the Commodity Exchange Act, and they should have remedies under the common law. But it is not an easy question.

Darcy knows, because she was at Bankers Trust when I was, that we had a huge new client approval process. Every institution does. You do a credit review, but then you ask "is this a suitable transaction for this person, and is it appropriate for the institution to engage with them?" Obviously, it doesn't always work.

QUESTIONER: One of the cases, which falls into what you are speaking about, is the case of a doctor named Tauber,[8] who is an incredibly wealthy individual.

MS. AINSLIE: The largest landholder in Washington?

QUESTIONER: Yes. This level of sophistication has really become the touchstone for liability to a certain extent. Who the counterparty is, and the nature of the participants doesn't just go to the size of the company, but the level of sophistication and the experience of the individual trader.

MS. AINSLIE: He at one point lost $24 million in his trading at Salomon. Now he had lots of trades with lots of other people, so you can imagine the financial wherewithal of someone who loses $24 million and continues trading at the same rate. Is that who we are talking about?

QUESTION: Do you think that the growing use of collateral, and perhaps daily marked-to-market instant collateral, presents a challenge to the exemption?

MS. AINSLIE: In what way?

QUESTIONER: Well, it makes an over-the-counter swap often look an awful lot like a futures contract if you have that collateral and you have daily marks against that collateral.

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8. *Solomon Forex, Inc. v Tauber*, 8 F.3d 966 (1993), *cert. denied*, 114 S. Ct. 1540 (1994).

MS. AINSLIE: That is one of the questions that have been raised and obviously there is not an answer to this yet. As long as it is a bilaterally negotiated contract with tailored terms based on the creditworthiness of the counterparty, it looks a good bit different than the requisite margining for a standard contract that you can only get in *X* amount for *X* period of time. I think that is an issue that gets discussed. But there are bilaterally negotiated terms for collateral as well as for economics.

QUESTION: When you pointed to the lack of a public policy concern as a fundamental basis for not regulating over-the-counter derivatives, how does that dovetail with the Long-Term Capital Management situation, where you have an unregulated entity that presented a—perceived, anyway—systemic risk to the economy?

MS. AINSLIE: That is an interesting question. A group of hedge funds got together and, about two weeks ago, released a paper[9]—I don't know how many of you are aware of this—which talks about risk management within hedge funds and things that they should do, in effect, to self-regulate.[10]

Long-Term Capital was a very unusual circumstance. There was a lot of talk about systemic risk. I was recently at meetings with a number of people in Washington where they were saying that none of the fourteen or so counterparties were at risk for more than $300 million, and in not one of those cases would a $300 million loss have presented a severe material impediment to that particular institution, let alone to the system. So while the issues are all correct, it is a very unusual circumstance. Long-Term Capital was clearly one of the most sophisticated counterparties anybody could work with.

Thank you.

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9. SOUND PRACTICES FOR HEDGE FUND MANAGERS (February 2000), *available at* http://www.hfmsoundpractices.com/Fund.htm.

10. *See* Press Release, Hedge Funds Publish Sound Practices Recommendations
(February 2000), available at <http://www.hfmsoundpractices.com> (last visited Nov. 15, 2000).

THE PRESIDENT'S WORKING GROUP REPORT AND OTHER INITIATIVES

PROF. RECHTSCHAFFEN: Professor Felsenfeld will navigate us through the rest of the morning session and then we will break for lunch. I am going to ask Professor Felsenfeld to return and lead us through the rest of the morning.

Are there any questions about what we have talked about so far? It has been pretty straightforward. We have gone through some of the utilization concepts in derivatives and capital markets trading, and some of the ways that risk management is superimposed on top of that. Now we will move into some of the government's reactions to derivatives and capital markets trading and to certain risk management issues with two of the leaders in the field.

PROF. FELSENFELD: During the next hour we will deal with matters being taken up in Washington relative to the control of derivative risks. We have two leading experts here to talk about this.

Michael Brosnan, Deputy Comptroller of the Currency, is a career Examiner who was most recently moved to a policy-making position. He deals generally with trading activities, largely in national banks which the Comptroller supervises, which means that he looks at the asset and liability side of national banks in order to help control their risks.

We are also very happy to have Darcy Bradbury. Darcy is out of Washington. She was an Assistant Secretary of the Treasury, one of the creators of the President's Working Group on Financial Markets, and was a leader in that field and is very aware of what is occurring in that field. She joined Deutsche Bank and recently left, I don't mind saying, for a maternity leave to take care of her six-month-old child. We are very happy that you took the time to come here. Darcy Bradbury.

DARCY BRADBURY:* Thank you and good morning. I am going to try to give you an overview of some of the current

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* Managing Director, Bankers Trust/Deutsche Bank, Strategy and New Business Development for Global Investor Services.

regulatory and legislative efforts from more of a political policy perspective. This will hopefully ease you into your afternoon, which is a little more practical, applied litigation, and may give you some idea of where I think the regulators and the legislators may be going in the coming months.

Ruth Ainslie gave a very good overview of where things are, but also highlighted some of the risks that exist in the current market for derivatives. While the litigators are busy helping clients take advantage of some of those risks, I think the goal in Washington is obviously to reduce risks in order to help the financial markets prosper and help our economy.

Let me start with a little bit of background on the President's Working Group on Financial Markets. It is made up of the Secretary of the Treasury, who chairs it, and the Chairs of the Board of Governors of the Federal Reserve System, the SEC, and the CFTC. It also includes, on a de facto basis, the heads of the OCC, Mike Brosnan's boss, the Office of Thrift Supervision, and the New York Federal Reserve Bank, who are the eyes and ears both for the Treasury and for the Federal Reserve in the financial markets based largely in New York. The group was created by Presidential Order after the 1987 market crash. That was the first time Washington figured out that there was an actual link between the cash markets and the futures markets and that the various regulators really needed to talk to each other to figure out how they could better coordinate things so that there wasn't a total meltdown of the financial system.

If you look back to when we started using it again, it was at the beginning of the Clinton Administration, in 1993, and you had a whole new group of regulators. In many cases, some of these positions were still unfilled or had holdover people. There was a lot of uncertainty and legislative pressure to do something about derivatives. Then-Chairman Gonzales of the House Banking Committee, and even the ranking Republican, Mr. Leach, who is now of course the Chairman, were very concerned about derivatives. And on the securities side as well, you had Representative Ed Markey very concerned about the growth in derivatives and this unregulated marketplace.

Sheila Bair, who was then the Acting Chair of the CFTC, put out a congressionally mandated report about the derivatives market in October of 1993.[1] In that report, she recommended that we revive the Working Group. Frank Newman, who was then at the Treasury under Secretary Bentsen, recommended that we do this as well.

So we went forward. It is truly a working group, and that is important to remember. It is not a regulatory body. It doesn't take any authority away from any of the regulators. That is the main reason why it works. Each of these regulatory agencies is quite particular about protecting their prerogatives, and their markets, maybe at times even slightly favoring their market participants over others in terms of new developments and how things should be handled. They did not want and would rebel against any kind of super-regulator put in place.

The Working Group creates a mechanism for communication and for coordination. It works on two levels. One, is that the principals actually meet. We used to have a meeting roughly every six weeks. In this big board room around a large table you have the Secretary of the Treasury, Chairman Greenspan, Chairman Levitt, and a couple of different CFTC Chairs over the years, the Comptroller of the Currency, and it is a pretty significant, weighty group, and they actually do talk about issues.

We had an agenda. But I will tell you, the meetings are very private, very limited in attendance, and it is an opportunity for them to talk about issues that worry them, whether it's settlement risk or Russia or Mexico or whatever the issues were, not just derivatives. But derivatives were a primary focus at the end of 1993 going through 1994.

You will recall that the first big challenge came in the 1994 interest rate break, when in the spring of 1994 the Fed raised interest rates and the market reacted much more dramatically than anyone expected. A number of highly leveraged situations began to unravel. The market had been largely betting on stable interest rates, and suddenly rates were not stable. You had things like the David Askin/Granite Partners situation. Later that year, you had Orange County, which, as a major public institution dominated by Republicans, attracted a lot of interest on Capitol Hill.

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1. Commodity Futures Trading Commission, OTC Derivative Markets and Their Regulation, (Oct. 1993).

The Working Group and each of the individual regulators were under enormous pressure from Congress to do something about derivatives. What the Working Group enabled them to do was basically to all hold hands and present a united front to Capitol Hill to prevent what they viewed as unnecessary legislation.

It sort of climaxed when Senator Alfonz D'Amato, who in early 1995 was the Chairman of Senate Banking, sponsored hearings on Orange County and the need for legislation, and each one of these Chairs was able to sit at the table in front of the Senate Committee and say "No, we don't need more legislation. We are using what we have and we are adapting it to changes in the marketplace." We were able to put out reports, which we have since updated regularly, showing all of the actions that the various regulators had taken to give Congress, the public, and others interested in this area a sense that a lot of things were being done and that no further legislation was necessary.

That was pretty important because I think there is a general sense that this market evolves so quickly that legislation is not always the best alternative. Legislation takes a long time to come to fruition, and once it is there, you have a lot of confusing words and phrases, which might be very good for lawsuits but are not really good for the market participants. And so the more we used existing legislation and, through examinations or supervision in the case of the banks, or through regulatory actions that can be more promptly amended by the SEC and the CFTC, the better off we all thought the markets were.

That leads us into the current Working Group's legislative proposal. In your packets you got a summary of Secretary Summers' testimony on February 10th before the Agriculture Committee.[2] By the way, if you are really interested in any of this, you should go to these government agency Web sites, which are quite good, and print all of this testimony and different reports. You can download everything and look really smart when you write your next brief, quoting from one or another.

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2. U.S. Treasury, *Treasury News—Treasury Secretary Summers, Senate Committee on Agriculture, Nutrition and Forestry* (Feb. 10, 2000) available at <http:/www.ustreas.gov/press/releases/ps385.htm>.

This legislative proposal, I would characterize as the first Washington monument ever proposed to a former CFTC Chair. That comes about as the result of a very controversial CFTC Chair who took a number of actions that undid a lot of the cooperative approach to this marketplace. These actions made the regulators and the market participants fear legislation less than they feared the potential for a single person or a single agency to undo years of hard work.

The derivatives regulation, and the legislation and statutes that govern, are sort of a mixture of actual statutory language, various agreements, exemptions that have been given, and sometimes agreements which have then been codified. It's a bit of a patchwork kind of system, which has worked by and large. There has, however, been ambiguity.

The industry has, in the past, asked for legislative clarity. In particular, there was a case regarding the Treasury Amendment on foreign exchange transactions, which was referred to in the question-and-answer period before, which went all the way up to the Supreme Court,[3] and essentially had to do with how one should interpret various prepositions such as "unless," "in," and "on." It was kind of remarkable. You would think that the Supreme Court would have slightly better things to do with their time.

The Treasury Amendment was designed to keep the CFTC out of the markets for government securities and foreign exchange, which were deemed to be global markets between very large sophisticated participants. Nonetheless, they were trying to tackle an issue of retail fraud, and so they were unwilling to cede their authority, and there was this big tug of war going back and forth.

Then, in 1998, the then-Chair of the CFTC took two actions which pretty much electrified the regulatory community, if such a thing is possible. One was a Comment Letter to the SEC on some proposal the SEC was considering.[4] The other was a Concept

3. Solomon Forex, Inc. v. Tauber, 8 F.3d 966 (1993), *cert. denied*, 114 S.Ct. 1540 (1994).

4. See Nikki Tait, US Futures Watchdog Says SEC Exceeding Authority, Fin. Times, February 27, 1998, at 25 (reporting that in a letter to the SEC, the CFTC stated that the SEC proposal "would attempt to regulate a large number of OTC derivatives transactions beyond its jurisdiction, many of which are subject to the exclusive statutory jurisdiction of the CFTC").

Release which indicated that the CFTC was considering a very fundamental change, where the CFTC was really going to start regulating the OTC derivatives market.[5]

I have never really seen anything like it in my years of watching Washington. Within the afternoon, there was a joint press statement signed by Secretary Rubin, Chairman Greenspan, Chairman Levitt, and I believe the New York Federal Reserve Bank President William McDonough, as well.[6] The statement basically lambasted the idea, saying that the CFTC was injecting an enormous amount of legal uncertainty into the market for OTC derivatives that could have a devastating effect on that market, by suggesting that they were subject to oversight by the CFTC and, therefore, that they were potentially illegal because they had been done off-exchange.

They requested legislation, and promptly got it, which basically put a moratorium on the CFTC until March of 1999, at which time there was a new CFTC Chair.[7] So I think it was pretty clear what they were trying to accomplish. They wanted to reign in what they viewed as a "rogue" regulator trying to change the whole scheme that had been worked out.

I can say these things. Mike can't because he is a current regulator. But it was quite extraordinary. You really don't see this sort of thing happen. And the meetings, I gather, were quite heated.

Then they were asked by Congress as part of this moratorium to put out a report saying, "All right, what legislation would you propose?" In November of 1999, they put out the Working Group Legislative Proposal.[8] They testified before the Senate Agriculture

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5. CFTC, Concept Release, Over-the-counter Derivatives, 63 Fed. Reg. 26,114 (May 12, 1998).

6. *See* CFTC Seeks Public Comment as it Reexamines Oversight of OTC Market, 30 Sec. Reg. & L. Rep. (BNA), at 721 (May 8, 1998) (discussing the CFTC Concept Release and the reaction to it from the Treasury, Federal Reserve Chairman Alan Greenspan, and the Securities and Exchange Commission).

7. *See* Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 § 760(a)(3), Pub. L. No. 105-277, 112 Stat. 2681 (1998) (imposing a "restraint period" to expire March 30, 1999).

8. THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, OVER-

Committee and the House Agriculture Committee, both of which have jurisdiction over the Commodity Exchange Act, about two weeks ago, and summarized the proposals. I am going to go briefly through those.

Before I do that, I want to just read one paragraph of this testimony because I actually think it sort of summarizes where the regulators stand from a policy perspective. It is in Secretary Summers' testimony. It says:

> The [Commodities Exchange Act] is designed primarily to address issues of fraud, manipulation, and price discovery. Sophisticated participants can protect themselves against fraud or can seek legal redress if they are defrauded. There is little evidence to suggest that markets for financial OTC derivatives are readily susceptible to manipulation. And, in the case of derivatives based on securities, existing securities laws would in any event be applicable to any attempts to manipulate security prices. In addition, financial OTC derivatives do not yet serve a primary price discovery function. And the activities of most OTC derivative dealers are already subject to direct or indirect federal oversight.[9]

So that starts with "what's your question, what problem are you trying to solve here, and why would you want to propose any kind of regulation or any kind of legislation over these markets?"

It is pretty clear that the whole point of government involvement in financial markets is to protect people who cannot protect themselves and to prevent manipulation which might have a broader impact on the economy. So if corn prices were manipulated extraordinarily through the futures market, that would have a fundamental impact on the American grain economy. So you have to think back to why the government is involved and what is the point.

The last point is also very important, and that has particularly been brought to bear with the developments in the last ten years in the derivatives markets; that is, you can regulate the participants or

THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT (1999) *available at* <http://www.ustreas.gov/press/releases/docs/otcact.pdf> (last visited Apr. 15, 2000).

9. U.S. Treasury, *supra* note 2.

supervise the participants much easier and much more effectively than you can regulate any particular instrument, because these instruments and these markets are morphing. So, one day it's a security, the next day it's a bond contract, then it's a swap, and then it's an insurance product—because insurance is the new unregulated industry as far as they are concerned. So Washington has sort of figured out that it is much easier to try to work with institutions, to think about their role in the economy and to only do the things you need to do to keep the financial markets working safely. We don't need to get involved in each and every thing.

Now let me very briefly go through these proposals because I think they are going to make a lot of sense, given what you learned from Ruth's presentation. The main purpose is reducing uncertainty and confusion.

The first thing is to codify the exclusion from the Commodity Exchange Act for most swap agreements. That goes back to the Futures Trading Practices Act of 1992, which said that the CFTC could issue an exemptive order. They did, but the actions in 1998 proved that what they give they can also take away. Nobody was comfortable with that, so they want to codify that exemption.

Exempted transactions have to be between eligible counterparties, sophisticated participants, as they were defined. The only exceptions are for non-financial commodities with a finite supply, once again getting back to this issue of markets that could be manipulated or where there are some price discovery issues that have a broader policy implication.

Although the proposal excludes energy, agriculture, metals, and those kind of things, I also think politically, that there is likely to be some attention given to energy before a bill actually makes it out of Congress. This is because with all of the deregulation going on in the energy field at the state level and with parties, such as Enron playing such a large role, I can't believe they are not going to want to also have some ability to conduct transactions without CFTC oversight. That is an opinion. But it wouldn't surprise me, and a couple of people I have talked to suggested that that is a likely outcome. However, this Working Group didn't feel they could opine on the energy market, because it is not being their jurisdiction.

The key thing is equity swaps. In particular, there has been some confusion because the CFTC and the SEC both have some jurisdiction in these markets. Codification will help a lot and will get rid of this ability of the CFTC to take back the exemptions.

The second thing that is kind of interesting, is an exclusion from the Commodity Exchange Act for electronic trading systems. What is interesting is that the report also says "but at a later stage we may need regulation." What they are basically saying is that they do not want the CFTC to regulate these markets in particular, and they want to let a few flowers bloom before they figure out what is going on with these electronic trading systems. They specifically said that the existing regulated exchanges in Chicago, the futures exchanges, can create unregulated electronic trading systems. So they are really trying to open the doors to what they believe will be a very growing market.

There are certain requirements for what qualifies, but they did put an important caveat at the end that maybe in the future there might be some regulation or statutory authority needed, but not the CFTC and not now. So that is an interesting perspective.

I think that is also a recognition that these trading systems are going to develop. They are the easiest things to take offshore and to operate through your London subsidiary or through an insurance subsidiary or a company in Bermuda. So there is really no point in the United States trying to regulate what would then become an ever-shrinking part of this market.

The third thing is to permit use of regulated clearing systems as they connect to these electronic systems. They still want those regulated, and I think they still see an important policy issue around clearing systems different from trading systems. The Working Group likes clearing systems, and they generally like netting. As Ruth was pointing out, netting has the ability to reduce the risk enormously. Instead of me having to pay you 100 and you pay me 102, we are looking at a risk of two, and that is a very different kind of perspective.

So they want to encourage clearing systems. Clearing systems reduce systemic risk, and they would help these electronic trading systems by getting rid of credit issues. But clearing systems that are poorly done can also concentrate risk, so there is a feeling that they do have to be regulated.

If you look at the report, they are all over the place about who should regulate them—the SEC could regulate it; the CFTC could do it; they could be part of a bank, in which case they would be regulated maybe by Michael Brosnan (OCC) or someone else. So they are not saying there should be one regulator, but they are saying someone needs to oversee the clearing systems. I think that is also very consistent with international developments, where regulators in other countries are looking at clearing systems and looking at global clearing systems. I think they would be unwilling to accept an unregulated clearing system. So I think that is an interesting exception.

The fourth thing is to clarify the Treasury Amendment to absolutely exclude the CFTC from derivatives that relate to exempted instruments, like government securities or foreign exchange. You would think the Treasury Amendment would have done that. It was drafted and put into law in 1974. However, because the language was not that helpful, they are going to clarify that and make it very clear that the CFTC has no authority in this area.

As a sort of consolation to the CFTC, they are going to give them explicit authority to go after retail fraud in foreign exchange markets, or I guess in these exempted markets generally. They are going to define that very clearly to make it obvious that it does not stem from their broader powers under the CEA, and that it is really a very specific power provided by this statute.

I do not know if any of you commute to work by car, but if you do, you hear these advertisements on drive-time radio for "come make your fortune in the futures exchange." There can be fraud, I think, in those markets at the retail level, so it is good to have someone looking out for that. The industry opposed it for a number of years, saying the state regulators could take care of it, but the reality is that it is very hard for them to do that.

The last two things the testimony categorized as technical. I think they are also a little political, so I do want to comment on them briefly. They have to do with jurisdictional fights.

Hybrid securities, which are ones that the CFTC claims jurisdiction over and the SEC claims jurisdiction over, can be exempted. That is clear, and they are going to limit the exclusive jurisdiction clause of the CEA, so that, basically, it will give other regulators a fair fight.

It is quite extraordinary that they propose these things. I really think it shows you the fact that this Administration and this Federal Reserve are very pro-industry, and very anti-regulation of the financial markets. Despite all of the problems, despite Long-Term Capital Management and those other issues, I think they basically want to stay hands-off. They want to get involved where there are particular situations, whether it is Bankers Trust, Procter & Gamble, or Long-Term Capital, but they do not want broad regulatory schemes that are going to really drive the business offshore. That is a pretty bold thing for regulators to do, to be honest, and I think they deserve some credit for taking that kind of perspective.

I think Congress would be perfectly happy to meddle, to be honest. They pass laws, that's what they do for a living, and so telling them that you don't need a law passed is actually a pretty rough thing to do when you are a regulator, because then if something goes wrong, you can be held responsible.

Interestingly, I think there is another issue that is related to derivatives but is of much greater interest to the regulators right now. Mike is going to talk a lot more about that. That is the issue of leverage. I think if you read the report on Long-Term Capital, or if you look at some of the things the BIS is doing, or even recent statements by Chairman Greenspan in his Humphrey-Hawkins testimony, or Chairman Levitt, they are all looking at leverage. So it will be very interesting to see how efforts to reduce the amount of leverage in the economy play through various regulatory schemes.

If I were to give you a tip of something to watch for out of Washington, look for things that relate to leverage and how they can try to decrease leverage in the market. So far, they are mainly using their bully pulpit, but they have other tools at their disposal, and I think it will be quite interesting to see if they start to use those to deal with what they probably see as the major threat to smoothly functioning financial markets in the future.

I am going to turn it over to Mike now and his PowerPoint presentation.

MICHAEL L. BROSNAN:** Thank you, Darcy. She has

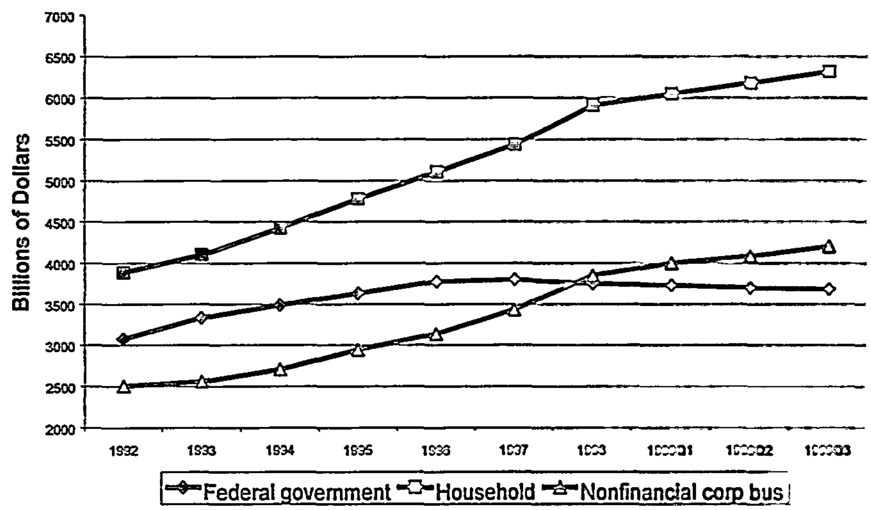
**Deputy Comptroller for Risk Evaluation, OCC.

been away from Washington for a little bit, but she certainly knows what the real issues are and she is able to give you a little more detail than I would about some of the politics and the personality issues.

As Darcy indicated, leverage is the issue. We can look at LTCM or hedge funds on a micro basis, or you can look at derivatives. But when you pull back and see what the issue really is, it really has to do with the amount of debt and how much leverage is in a marketplace and how some very large firms have grown up and are very heavily leveraged. If something happens to one of them, what are the implications in the marketplace?

I am going to walk through some numbers to put some tangibility to this concept of leverage, and then I will very quickly give you a *Reader's Digest* version of the two reports that came out last year.

I have tried to slice and dice this a lot of different ways for the CEO of my organization and other senior people, and it is tough. So how do you get people to understand? When you talk about leverage, it's a multi-syllable word and it sounds fancy and you know you are supposed to have high respect for it.



<u>*Fig. 1: Borrowing By Sector*</u>

Source: Flow of Funds: Accounts of the U.S.

I think the best way to do it is in dollars. We can do it as a percentage of GDP or year-on-year growth, but people relate to dollars. Figure 1 represents borrowing by sector. The scale on the left which is in billions, so we are looking at many trillions of dollars of debt.

This is not like looking at notionals. As Ruth was saying this morning, you look at notional amounts from derivatives. Well, how much risk is that? Well, it depends on the term of the contract. You know, a three-day FRA is the same as a thirty-year interest rate swap as far as notionals go.

So here we are looking at real debt. This is what people are borrowing in the marketplace in order to conduct their operations go. The big line on the top is household debt. There are some mixed reactions as to how big and how important that is, because it includes secured debt in addition to unsecured credit card loans, unsecured second advances on your homes, things like that. This is easily the biggest number.

Something I didn't think I would see in my lifetime, particularly when I was coming out of school and going to work in a financial environment, is that the Federal Government would have less debt outstanding than corporate America. Sure enough, miracles happen, and we have it. It seems like this trend where one goes down and the other one goes up could keep going.

Figure 2 represents nonfinancial corporate capital expenditures and cash flow. Why is corporate debt growing? The top line for the most recent period is capital expenditures. The bottom line is cash flow from operations. So as productive and with as much revenues and success as U.S. corporations are having in the aggregate, their cash flow from operations is short of what they need to expend in terms of new plants, technology, and things like that, to keep up and be productive. It is extremely competitive broadly across the system, and all this debt and all these expenditures on new plants and equipment have created a huge amount of capacity. So there is not much room to raise prices because everyone has a lot of capacity to produce product and sell. With this shortfall between cash flow from operations and what they are spending on plant and equipment companies have to issue debt. That is why this line is going up, almost on a 45-degree angle. It is real money; it's not like you're going from \$100 to \$200—we are talking trillions here.

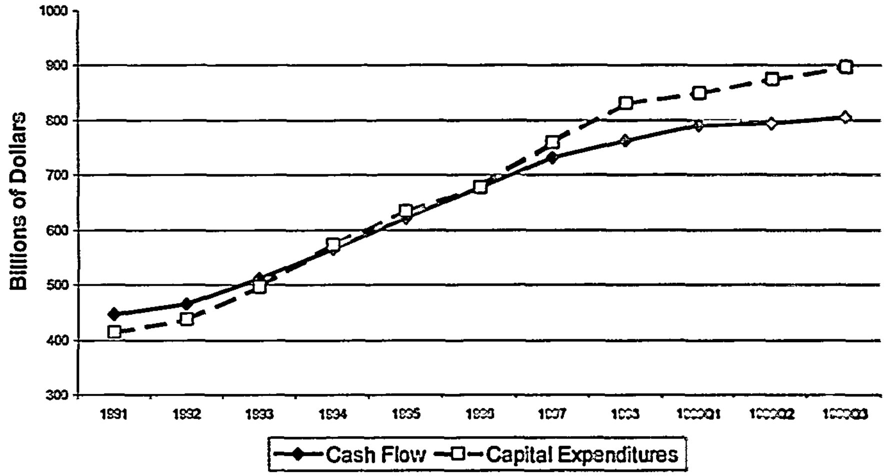


Fig. 2: Nonfinancial Corporate Capital Expenditures and Cash Flow

Source: Flow of Funds: Accounts of the U.S.

The other thing that is causing corporate America to need to issue more debt and leverage itself up higher is this very strange pressure to have the March 31st earnings per share number be a good number that appeases not just the analysts, but whatever the so-called "whisper number" group is. This pressure has always existed, but never to this degree in my short lifetime. One of the ways you can do that is to sell products and achieve profit margin, and get net income from that, or you can somehow change the denominator, which would be the number of shares or your equity base. So they buy back stock in part, and it's a mix. You are looking at revenues, expenses, and buying back stock. You need to issue debt to buy back stock, so leverage goes up.

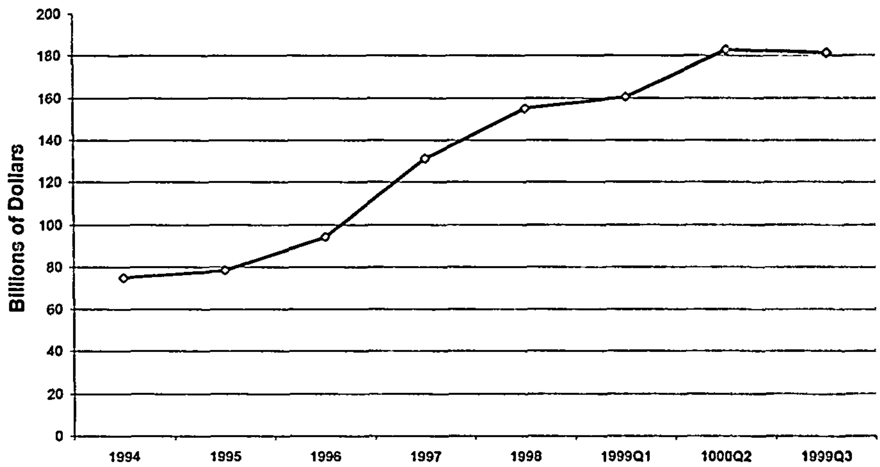


Fig. 3: Security Credit

Source: Flow of Funds: Accounts of the U.S.

Here I just have U.S. numbers, but you know that the United States is not the only country in the world that is feeling this. Certainly we have it more than anywhere else, I believe, but it exists elsewhere around the world.

Figure 3 shows the total amount of security credit in billions of dollars. This is a smaller number than the actual present amount. I know the real number was north of $200 billion around the holidays when it was released, but we don't have the official report so I can't put it in my graph. So it is only $200-something billion, which with the numbers we are talking about here doesn't seem like a lot, but to me $200 billion is a lot.

This is a psychological barometer, I think, where people are willing to borrow to buy equity. So you are looking at equity as a leverage play. You borrow to buy equities. Clearly, anyone who has done this over the last decade, a much smarter person than I, made a killing just by having a diversified portfolio. They didn't have to be able to pick Microsoft or Cisco. But someday if the market tips down, you've got to pay this back, and the cascading effect that results is out there. So, in a nutshell, this is cash leverage, things that are real tangible. It's not a notional amount. It's real debt that is out there.

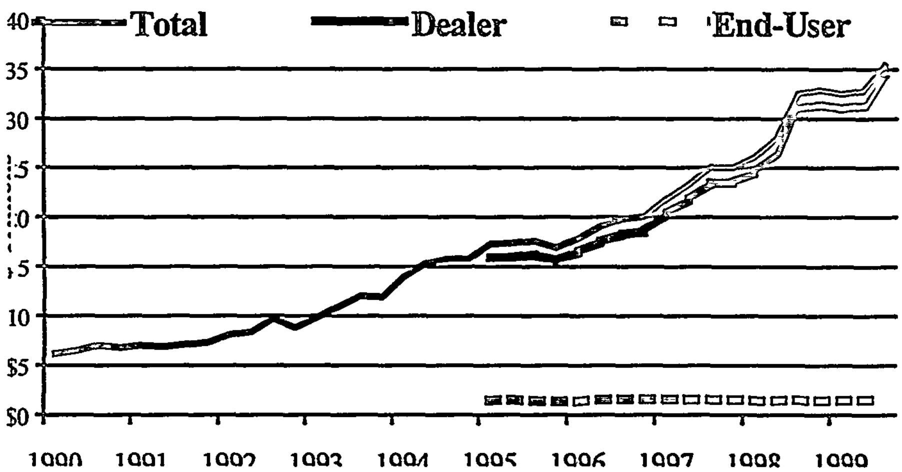


Fig. 4: Derivatives: Notionals by Type of User
Source: Flow of Funds: Accounts of the U.S.

Figure 4 shows a number I've got to be very careful in explaining. This is what Carl was talking about earlier. This is the $35 trillion of notional amount of derivatives that existed in the U.S. banking system as of September 30, 1999. That is the thin line. The thick line is the notional amount for dealer transactions. That is where Merck comes into Citibank—I'm just making this up—and they do a transaction where Citibank goes out on the other side and lays off that transaction to capture the spread. They lay it off with, let's say, Barclay's.

The bottom line is a really curious number. It represents end-user transactions. I wouldn't have mentioned this, but Ruth brought it up. I think that the story behind this may be as much or more risk than the big notional amount of derivatives. You see a very small amount of all the notional amount of derivatives in the banking system is actually used for their own positions—that is, to hedge liabilities, assets, or other off-balance-sheet positions. So it is just a sliver.

The real concern I have is that only 5 percent of the 9,500 banks in the United States use any derivatives at all. So they will go ahead and take three-month and six-month deposits, make you a five-year/seven-year/fifteen-year/thirty-year mortgage loan, but they are afraid to buy a cap because it is a derivative. And there is this fear about derivatives, because if you lose $10 on derivatives, it has about the same press and internal Board of Directors implications as losing $100 on loans. So obviously you just scale that up by thousands or millions. I don't know why it is like that, and it is not fair, but it is.

You can also have leverage through derivatives. The vast majority of these transactions are no money down, so you have an asymmetrical payoff. You can get a good return or you can feel some loss if currencies or interest rates or the price of oil move, depending on whatever this contract is based on.

So we are very sensitive to these 45-degree angles, and it is a growing trend now. Of course, we are in great economic times and you expect things to move. The fact that derivative notionals move up is not really all that meaningful in terms of risk, though. It does not tell me how much risk is out there.

Something I can tell you, for whatever informational benefit it has to you, is that U.S. banks do not, and certainly the national banks do not make much money on proprietary trading of this dealer amount. They have very little of their desks bet on that, and they are just not willing to make or lose a lot of money.

The biggest value at risk (VAR) of any national bank is about $100 million. That is their biggest corporate worldwide limit. What does that mean in real terms, because $100 million again remains a big number to me? It means about 1 percent of their capital base. I have never seen a national bank lose that much in any given day, no matter what happened in 1997 or 1998. If you were going to take a bet during that time, you were either going to win big or lose big. So it just does not happen that you lose 1% of your capital base in a single day. They do mostly dealer-to-customer transactions, principal-to-principal. So you get leverage from this.

Let me put a number on this. How big is the risk from derivatives to U.S. commercial banks? For the top seven banks, it is anywhere from two-to-three times their capital base, as shown in Figure 5. This is a big number. That is from credit risk. It is not from having unhedged positions, which they all have, which are small. It is from taking credit risk, the principal-to-principal activity that takes place.

When Citibank does that transaction with Merck and with

Barclay's, those are two independent transactions and they are vulnerable to the risk that either party might not make its payment. That is how Citibank is going to earn its pay, or Chase, or any other bank that is in the derivatives business.

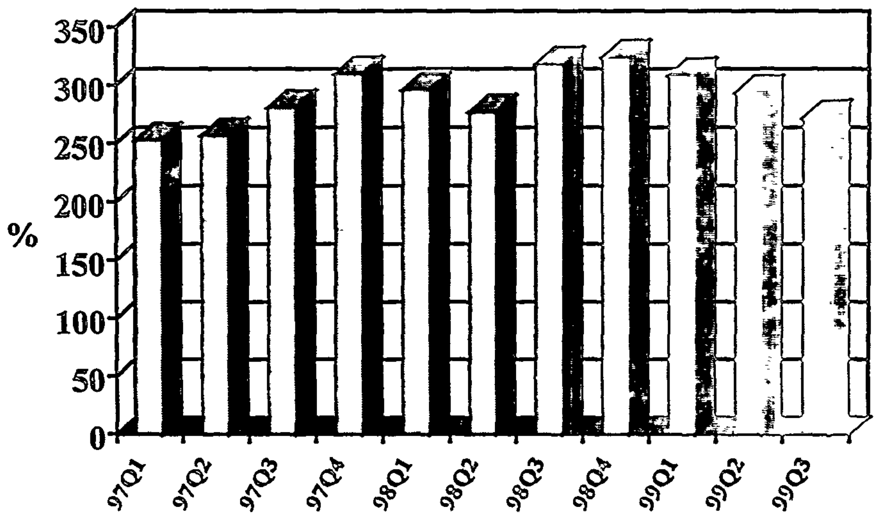


Fig. 5: Top 7 Banks % Credit Exposure to Risk-Based Capital
Q2 99 = $363 billion in total credit exposure from all commercial banks
Q3 99 = $387 billion in total credit exposure from all commercial banks
Source: Flow of Funds: Accounts of the U.S.

So this is real money. We calculate the credit risk equivalent amount at about $350 to 356 billion as of March. This amount has remained pretty stable. Of course this graph moves around, but it is on a scale of 250 percent or so, plus or minus ten. So this is a big number and this is what leverage is all about.

If someone enters into a contract and he expects to be able to net and the other person expects to be able to net, we think that it is important that there be legal certainty in the marketplace. In the United States, you have pretty good legal certainty. All the court decisions, for the most part, have tended to provide that. But there was this specter out there, which Darcy spoke so gracefully about, that can introduce an unwinding of things that seemed to be good.

This can have a big numerical impact. If the worst scenario occurred in the *Dunn* case,[10] for example, it could have trickled out to these over-the-counter transactions being off-exchange futures. If the forces of darkness were able to prevail with that type of ruling and interpretation, then it is possible—not likely, but possible—that customers of banks would have said, "These are illegal contracts; I don't have to pay you." None of this money here has to do with exchange-traded contracts; it is all over-the-counter. That would have been a very bad thing for the banking system. I certainly would be unemployed had that occurred.

In a nutshell, the President's Working Group Hedge Fund Report recently came out. We had this little problem where a very highly leveraged firm, with a very large dollar asset base to boot, got into some trouble, and it had creditors who were exposed to that risk. At the end of the day—we never come out and say it's a unanimous conclusion—but the consensus, if not outright unanimous conclusion, is that the creditors failed to do their job there. Do we need to regulate LTCM? No. Do we need to make sure that banks, broker-dealers, and others who are providing credit whom we regulate do their job when providing credit? Yes. Did they do a good job there? In some cases, no. The people who had a lot of exposure to that highly leveraged firm without collateral and, in hindsight, without great financial information, probably will not repeat that mistake in the near term, at least if the same people are still employed. You need that institutional knowledge to keep this going, though.

What does the report say? The bottom line of the report is that it stresses the importance of market discipline. That is what is going to make this work or not. When we say market discipline, it is in the form of creditors making the right decisions on who they are going to do business with, in what size, and on what terms. How much money is involved? What are the terms? How do they make that decision? What do they know about their clients?

There is also an emphasis that the customers out there have a responsibility. Even if they are unregulated and not subject to SEC disclosure, they certainly have a responsibility to inform their investors and creditors of their financial situation and plans and strategies. But I don't blame LTCM. I blame the banks who did

10. *Dunn v. Commodity Futures Trading Commission*, 117 S. Ct. 913 (1997).

transactions with LTCM on terms that, with 20/20 hindsight, were probably not the best calls. So we also look for creditors to do better on risk management, particularly in how they measure risk. When you look at this $35 trillion notional amount, all you have to do is a series of calculations on how much credit risk there is, to actually make a prudent decision. That requires you to have reasonable estimates of what can happen to currencies, interest rates, commodities, et cetera; and not just based on the last ninety days. What if history is unkind and the last ninety days don't occur but yet you have a break? That is where you find out if you have enough collateral and if you actually had too big of a credit exposure.

We confess that we need to have more effective, sharper supervision going forward—not that we don't understand what is going on. I think this is not nearly as sophisticated or complicated as certainly the *U.S.A. Today* would play it out. But this is big, and it is all over the world, and it happens very quickly. It happens while I am asleep. What we need to do is to be very sharp in terms of how we allocate people, and what rules we put on banks. It is not in the form of laws or statutes or regulations, because they are inflexible and difficult to change. Instead we must consider what policy expectations do we have to which we then hold the bank responsible? So we have to be smart in how we do that.

We also have to be smart in how we change capital rules. The risk-based capital process provides a great incentive to either skew business one way or another or out of certain things. So we've got a great window—and Bill McDonough from the New York Fed is chairing this process now—to actually raise our standards and do things a little bit more prospective and proactive.

The bottom line in this report, which bleeds over into the next one, is that in 1998, the Secretary of the Treasury provided draft language that Congress could use to enact laws that would enhance legal certainty for derivatives. So in this Hedge Fund Report, we take the opportunity to remind Congress that this is a good thing to enact. And there are actions toward that end, which I will talk about in a second.

The latest report, which Darcy just covered, is all about enhancing legal certainty, looking at the definitions of the contracts that we are talking about, and where we can, broadening them.

The whole idea is to have certainty regarding close-out netting and how collateral can be liquidated under difficult times. The LTCM situation brought some uncertainty, but what would have happened if they had filed for bankruptcy in the Caymans? Their main place of business is here in the United States, and we do not have various languages in place that would codify that you could in fact do certain things in the United States if you are a U.S. creditor with U.S. based collateral.

Part of legal certainty involves the electronic-trading systems. The existing legal scheme or regime has been an impediment to entities like EBS and Blackbird from not just developing and improving their transactions, but actually doing them with U.S. customers, and, certainly in my case, with U.S. banks. In some cases, this type of technology makes the banks safer, more efficient, and easier to examine. But the way that we have our rules structured, they are not sure if they can implement their systems, at least prior to our unanimous agreement on this report, because somebody might be able to come out and say "you are operating an illegal exchange there," and then invalidate all their contracts. None of the banks want to fall victim to that. So some of these things—we are looking down the road—can improve the way that our markets and our banks operate.

Impediments to the over-the-counter derivative clearing system should be eliminated. It is unclear to me how we would actually do this, but the banks actually see a significant interest in doing this, and they will come up with ways. In the past, we have had MultiNet and other systems proposed. They just have not gone the full length as we would have hoped, but now that we are trying to remove these impediments, hopefully we will get there.

Last but not least, I would like to clarify the Treasury Amendment. Again, how do you minimize vulnerability in a *Dunn* case? The bottom line is leverage. And what will happen if a big firm that is highly leveraged fails? How can it affect the marketplace? How can we make sure that you in fact have netting and that you can liquidate collateral so there is a more orderly process, rather than having to wait around and have your exposure grow, so the cost would build from that?

Appropriately, the responsibility is, at least at this time, focused on those who supervise and the creditors who are actually making this credit available. I think it is not only the easiest thing for us to do, because we can go out and do it without creating laws or regulations. But it is also probably, far and away, the most effective way to do it, and it makes sense.

And then, what are we using the law for now? While the folks in charge can use the law to be more draconian and precise in imposing limits on what you can and cannot do, right now the law is being used to enhance certainty, which we think is a good thing.

Since these reports have come out, Congressman Baker, Congressman Markey, and Senator Dorgan—I think Markey and Dorgan are together on this—have come up with proposals on how to get better disclosures from so-called highly leveraged institutions or hedge funds.[11] Congressman Baker has proposed language that would do the same for hedge funds on his side.[12]

The Markey-Dorgan legislation also seeks ways to improve or enhance the ability of the securities regulators to cover broker-dealers, because they have what I think of as non-regulated affiliates, or at least affiliates that are less regulated than the broker-dealers themselves.[13]

The Basel Committee on Banking Supervision has processes going forward which are very parallel and consistent with what we are doing in the United States. IOSCO has the same thing. And then, there is this Group of Seven, where Ted Truman represents the Treasury and the United States on that panel, trying to encourage harmony and collective thinking that is hopefully similar, if not identical, to what we did in the President's Working Group on these various issues.

I think that is pretty much the best I can do in twenty minutes.

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11 *See* Conrad G. Bahlke, *Update on Proposals to Regulate Financial Institutions' Derivatives Activities and Hedge Funds*, BANKING POLICY REPORT, May 15, 2000, at 1 (discussing Rep. Edward J. Markey and Sen. Byron Dorgan's introduction of H.R. 3483 and S. 1968, respectively, to enact the Derivatives Market Reform Act of 1999).

12 *See id.* (discussing Rep. Richard Baker's introduction of H.R. 2924, the proposed Hedge Fund Disclosure Act).

13 *See id.* (reporting that the Markey/Dorgan bill would "Grant the SEC authority to regulate non-bank derivatives dealers, including the power to establish capital standards, record keeping and reporting requirements, anti-fraud, and sales practice rules").

We will take questions.

QUESTION [PROF. RECHTSCHAFFEN]: Several people in the audience today are from the Superintendent of Insurance Office of the State of New York. The area of derivatives and risk management is an area that they are beginning to focus on. Before you arrived, I mentioned that Susan Phillips, who you probably both know, who is a Federal Reserve Governor, said that regulatory structures in the future are likely to emphasize trading parameters, stress testing, process, and internal controls.

In light of what happened at Long-Term Capital Management, it seems that the conclusions seem to be going in the direction that the counter-parties have a real responsibility. Given the fact that we have regulators here who are looking to the next level of regulation that we should be imposing on these over-the-counter derivatives transactions, at least so far as to encourage best practices, what advice could you give the regulators who are here? Where do you see the ability to regulate best practices on a going-forward basis to prevent Long Term Capital's and Barings Bank's and whatever other exciting things the future might hold?

MS. BRADBURY: I will make one comment, once again using my fortunate position of not being a current regulator. Then I will let Mike talk about some of the excellent work the OCC has done in terms of looking at systems that institutions have in place.

Insurance is the "new frontier," and this is because fundamentally derivatives are either about making things more efficient or they are about regulatory arbitrage, and there are different derivatives for different circumstances. Insurance is viewed as an area where there is enormous ability to do regulatory arbitrage right now, because (1) you can go offshore very easily, (2) you have different state regimes, (3) there is, I think we would all agree, probably not very sophisticated insurance regulation of very complex instruments right now, and (4) in particular, insurance forms give you an ability to do tax avoidance, which is very popular.

So I think that if you talk to people who are kind of on the cutting edge of what's new, what's hot, it is all in the insurance area. How can we create an insurance product which is really a way to invest in the equities market but avoid taxation, or to do it offshore? So insurance is really just a very booming area. God speed to the insurance regulators, because I think it is going to be very hard to keep up with some of the developments in this area.

Do you want to talk a little bit about some of the things you are doing?

MR. BROSNAN: Okay. I will just try to focus back on your question of what sort of counsel would we give to the insurance regulators that are here based on our experiences. I have always understood, and I believe, that the insurance industry not only is regulated, it's probably highly regulated. I would emphasize supervision by a risk-type of approach.

The best template that came out early on was the G-30 standards. It was really "motherhood and apple pie," a series of almost Biblical truisms, of things that people ought to do. Yet, I assure you, there wasn't a single firm in the world at that time that did all those things. I am totally unaware of anybody that could do all the things that they were saying in that report.

But the people who wrote that report took a very high, honorable approach, and they wrote things like "this is what you ought to do if you are going to control your risk properly." So they set a high bar. That is what people ought to meet just to actually do their job properly and prudently.

The OCC put out a document, which we labeled Banking Circular 277,[14] which is largely similar to the G-30 Report. Obviously we can implement those things with national banks by saying "we expect you to do this, this, and this." If they are not doing it, then we go meet with the CEO or the Board of Directors and the appropriate things tend to happen—largely before we get to that point. Certainly once we are there, they do occur.

There are differences in our Banking Circular 277. We do not believe that this is a suitability issue. We believe that it is an appropriateness issue. There are principal-to-principal transactions here. When the dealer talks to the customer, they are not calling up and saying, "Boy, I recommend that you do these twenty-three swaps." There is a negotiation or an understanding that is going on, where the customer says, "I've got this series of

14. OFFICE OF THE COMPTROLLER OF THE CURRENCY, BANKING CIRC. BC-277, RISK MANAGEMENT OF FINANCIAL DERIVATIVES (1993) *available in* 1993 WL 640326.

transactions, I'm buying or selling goods or I'm issuing this debt; how can I swap it back to get either my best fixed or floating rate?" So then they present them with alternatives. I think that there is a difference.

We revolve our credit risk assessment around this appropriateness issue. First, you want to make sure that you can get paid back; but also, that you have a marketing and sales force in-house that is engaged in transactions with the customers, that make sure that the transaction is appropriate for clients. Why do you want to do that? You want to do it because, if they do an inappropriate transaction, the client could get blown up and perish and not be able to pay you back, which is not good for anybody. And then, on the other hand, you might do an inappropriate transaction with a client and they find out about it later on when they tend to owe money. It's almost always the case that they find out about it when they owe money. When they are owed money, it just doesn't come up. But when that happens, then the bank ends up in the right-hand column of *The Wall Street Journal* and there are shareholder problems and other matters that go on, which often have career implications there.

Let me see what else. We also issued, on the heels of LTCM, upgraded guidance in the beginning of 1999, basically all tailored to where we had three or more banks that had a problem in a certain area. We wrote "here was what the problem was and here is what the reaction was in-house, usually at the senior management or board of directors level, and here is how you can prevent this from happening again." And then, we put steps in for examiners to go look for these problems, so that banks would take appropriate steps.

Now, we are talking about a very confined pool of banks that do business with hedge funds and also do derivatives dealing, so it is easy for us to skew our resources there. My guess is that it is the same thing for the insurance regulators; just carve out sharp rules, set a high bar that your guys can use at a select group of firms, whether it's AIG or whoever, that is going to do this business.

The other thing I would comment on is risk-based capital. I have learned—I am not an attorney and I am not unhappy about that, but sometimes I wish I was— that we write these rules, as we did this in the mid-1980s, made them effective in 1988, and now we are trying to fix them in the year 2000, not fix them, but you have got to upgrade constantly. It is a very difficult process to go through.

One of the things is if you still have a fresh pen and can do this going forward, when you do risk-based capital, you realize that this market moves, and it moves fast. Under our Rules, when we compute a capital charge for a credit risk, we look at how much current net exposure exists there after you take into effect netting—you know, you've got to start there—and then what's the possible risk down the road. The add-ons that we use, pretty much stop at five years, so we don't have any discrimination between a five-year, a one-day, and a thirty-year contract, which didn't exist when we were first writing these rules.

We also do not discriminate based on quality of counterparty, so you can have a AA or AAA counterparty and they are charged the same capital charge as somebody who is a B quality counterparty, so that is not the best thing we could do.

So I would say two things. Tier your capital charges or reward business with better counterparties and then you hold higher capital for less credit worthy counterparties. And then, charge more capital for the longer dated transactions. You are going to find that that is where your credit risk is and that is where they are going to have a harder time hedging on the dealer side.

Also, collateral—while I don't see a lot of it in the banking system, it is growing, so it is going from a very small amount to something that is important. You want to give some incentive for institutions to take collateral. The people who owe money don't want to post collateral because it is expensive, but if you are a regulator, you like collateral and you like cash and you like T-bills. It's great to get Kingdom of Spain bonds, things like that, but your T-bills or Treasury notes are a beautiful thing to have, particularly when trouble comes.

We also did something that we have had for a few years, this market-risk-based capital, which we base on a value at risk calculation. We have our own answer to what time horizon and basically how many standard deviations you use. That has been somewhat successful, but I assure you that you better have something in addition to that, because the value at risk calculation is usually pretty good as long as whatever happens tomorrow or the next day isn't that far out of whack with whatever happened in that historical period that you are using as the basis for your calculation and the source of volatilities and correlations.

So I would say that I think that it makes sense to use something like that because you reduce risk to common denominators, which anyone can understand, and you demystify it on that basis. However, it makes sense to have, not only that, but other parameters out there. We watch banks, how they manage their risk. They still use a variety of other methods, including in some cases when they are in less liquid transactions they use maturity limits—"we won't have more than *X* amount over this amount"—and they will use old-fashioned things, fuddy-duddy things, like notional amounts. That is because these statistical calculations work the vast majority of times—and they are very helpful for all the reasons that these textbooks are written for—but in a time of crunch you want to have other things that are there to kind of circle the amount of risk that is out there.

That is probably not enough advice, but probably more than you were hoping for.

QUESTION: Michael, are your risk-based capital standards established by law or are they established by regulation, and can you convince the banks if you have a concern that they should have more than risk-based capital? Can you make them carry more capital?

MR. BROSNAN: In the United States we do it by regulation. The Basel Accord comes out, the Basel Accord is there, and we actually create regulations to implement these things here in the United States. Therefore, when we go to change them, we go through the whole process: propose a change, get comments in, perhaps modify the original proposal, and finally implement final regulations. We usually do not just come out and dictatorially change things because we are not so arrogant as to think that we can think of something and it will be right before getting thoughtful comments from a variety of parties. You would be surprised how many parties are for the industry and against it, so we get a pretty good balance.

So we do it by regulation. If we think a bank does not have enough capital, can we require more? And do we do that? Yes. It is just easier, because a lot of times you think they do not have enough capital because you just have a bad feeling about it. You see a lower concentration. Suppose you are in 1996 and you saw somebody with a lot of Southeast Asian currency transactions that are not wholly hedged—you know, if you had the foresight to say, "What if there is a break there; then these guys could be out of water if they are expecting any of that hard currency back to the bank." So we can ask for more capital, and we do do that on occasion.

Sometimes we have to use formal agreements to get it, but for the most part if we do go to a Board of Directors and say, "We have concerns about this, this, and this; you only have 10 percent capital now; we think you ought to have 12 or 13 percent," we can get that.

The challenge that I find, though, is when sometimes there is a financial person on the Board who says, "Well, how do you get that extra 300 basis points?" Then it is tough to say, "Here are my calculations." It is more just a sense that you have—"You really need 30 percent more than your peer group," and so on.

I think you need to have both of those. You always want to leave room in whatever codified level you have to add on more. In that way you can reward your better-managed institutions by not charging them more, at least officially. And then if you've got the outliers, you can charge them more.

QUESTION: In the financially modernized world, you are increasingly going to be bumping the federal regulatory structure against the state insurance regulatory structure. Under the state regulatory structure, the insurance regulatory structure, you tend to have more product regulation; you also have different accounting rules. You have these different sort of philosophies coming up against each other.

I guess my question is, where do you see the role of the state regulator in formulating policy towards the way risk management evolves and derivatives are regulated specifically?

MR. BROSNAN: That is a tough question. I'm hoping that you don't work for *The Wall Street Journal.*

While I work for the OCC—and I am very proud of the approach we take, and I buy into and believe in it, and in fact I am a party to actually writing how we do this stuff, so I am not totally objective on this—I think that nobody could say with complete certainty that our way is the best way and everyone should do it that way.

Professor Felsenfeld, in his opening comments, was talking about what I think of as the "joint forum"—I forget what he called it. But for years we have had working groups going out internationally, to determine how we can oversee these what I will call conglomerates. But really, you are talking about entities that are domiciled and doing the business of banking or securities or insurance all across the world, and how do you deal with folks in Singapore where, until recently, it was difficult to get in there and see what the firm had? We have had discussions on how to best do that internationally.

Tomorrow you will have Christine Cumming here. My observation is that she is probably the most knowledgeable person in the world on how that process has gone because she went through that for many years. It would be a good thing to ask her how that went. But this is also happening domestically because, under the Gramm-Leach-Bliley Act[15] ("GLBA"), this is what we are going to have. We are not going to have just a bank or just a securities house. It is going to happen one way or another. But now the law in fact tells us "don't meddle."

Historically, as an OCC employee, the law not only will let me do it, but also made me responsible for examining and understanding anything that was affiliated through a national bank. I will give you an example: before Chase was eaten by Chemical, if Chase had a Laundromat, for example—and they couldn't, but if they did—then I could go over and examine that laundromat, whatever that means. But now under GLBA, the way it is going to work is that the insurance industry regulates the insurance side, the securities folks regulate the broker-dealer side, and the other people just have to rely on reports.

But what I think is going to happen through these joint forums and the discussions that go on is that we will—not steal from one another—we will borrow from one another rather liberally the things that work well. Hopefully, we will drop things that are less efficient and less effective, because not only is there a shortage of resources on the regulatory side, notwithstanding what any

15. Public Law 106-102, 113 Stat. 1338 (1999).

bankers in here would say, at the end of the day, this business is getting to be so big and the transactions themselves are so large. With the number of customers that exist and the number of things that can go right as well as go wrong, it is a totally different scene than what it was in, let's say, 1992. In less than ten years, this whole thing has moved very fast. So we need to get sharper and better.

MS. BRADBURY: Also, I would add that you have to think about what your role is as an insurance regulator. What are you trying to stop? You know, the CFTC, the SEC, they are very focused on fraud; that is one of their big things. I think the Federal Reserve is much more focused on the smooth functioning of the financial markets. And so they focus their regulation or their supervision on the issues that are of critical importance.

I think the insurance regulators have a real challenge because of the fifty-state thing, to say nothing of offshore insurers that can operate here. So you would be wise to pick what you are trying to accomplish and focus on that and not say you are in charge of all those other things, whether the joint forum may give you an ability to do that.

I thought the Citigroup merger was quite striking. I don't think that Sandy Weill wanted to keep the insurance piece just because he wants to sell insurance policies retail. I think he wanted it because of the connection with this brokerage business, of the connection with all the financial products. You know, there are a lot of things that insurance companies are allowed to do that other financial entities are not, so there is also going to be regulatory arbitrage, and that says you have to step back and look at some bigger issues in these conglomerate firms.

That is almost going to require a two-tier approach for an insurance regulator to tackle, not unlike—you know, in Mike's organization there are people who go out and examine lots of little banks. They are looking at totally different issues than the people who go out and examine the big global banks, and they have to tailor what they are doing appropriately. But you've got to pick and choose what you are going to accomplish.

COMMENT: I think the regulatory arbitrage project is going to be a big one in determining who is looking at which of the perspectives, with the various regulators, with all the acronyms, that have some state implications on these joint committees.

MS. BRADBURY: I think certain state regulators can also be lead regulators, because if you have an entity that works across the country, you are going to have to work out some agreements just for your own sanity. So you are not only torturing them but also being ineffective, and you will have to decide who is the lead regulator for a particular company, or maybe for particular activities.

There is no doubt that New York has taken the lead in certain areas in securities fraud, for example, that have helped in other states, and maybe you will see that develop in the insurance industry as well.

QUESTIONER: Actually what I wanted to say was that now that both of the industries are going to cross over into each other's business—and certainly a big issue in implementing Gramm-Leach-Bliley is going to be the definition of insurance issue, and if you have a bank doing something and an insurance company doing the same or a similar thing which could be considered insurance, the state structure over the bank on the insurance side will become a big issue that needs to be worked out among the regulators.

PROF. RECHTSCHAFFEN: We have one more question and then we will adjourn to lunch.

QUESTION: Can I ask Michael to go back and look at the chart, the very interesting one, derivatives notionals by type of users, where the end-user amount is flat but the dealer amount keeps increasing? Two questions.

One, do you include derivatives used by insurance companies and hedge funds in the end-user column or the dealer column?

The second question is, regardless of how you define end-user, if you see that the end-user amount is staying flat but the dealer amount keeps increasing, what does that mean, because who is laying off the risk? Can I not make an argument that by using derivatives a dealer is not diversifying risk, but really is concentrating risk within the same pool of its fellow dealers? I find that chart fascinating and interesting.

MR. BROSNAN: I have used this chart for many years. First, this notional amount and this data solely applies to U.S. banks. It is only what U.S. banks had on September 30th. So I don't go out and get insurance companies and put them in there.

Now, the U.S. banks may well do transactions with insurance companies, and I assure you that AIG and others are major counterparties and the hedge fund community is a huge client of several of the large dealer banks. So those transactions are in there, but they are always at the origin of how the U.S. bank has gone out and done those.

This number goes up because the activity is increasing in general as the world grows. As you see all this debt growing, people issue debt and they say, "What is the sweetest spot in the market, floating or fixed?" But that may well not be what they want for their firm, so they issue fixed and they will convert it back into floating. And so, as the world grows, you are going to see this number grow. So activity is up, and it is up because you have growth in the world in general.

The other thing that is happening, and as I was talking about in my suggestions on being careful with risk-based capital if you don't already have it, is that the tenors are growing out. So you do have a lot of short-term transactions that just tend to roll over. Anything under ninety days just rolls on and rolls off, so it tends to be self-feeding. So for a $100 trade, it insures it for another $100, that sort of thing. But with the tenors going out as they are, the longer-term deals stay there, and then all the new ones are just added on top of that. But also, the bank takes a long position and they offset it with a short position, so you are doubling up. So every time you do a $500 million trade, this thing goes up $1 billion. If it is for five years, this stays on that chart for a long time, and then all the new ones get added on too.

The issue about the end-user positions being flat, that bothers me, you bet. My number one concern is that only five percent of banks are using derivatives, so we do not have a lot of banks that use all the tools available to hedge. We do not encourage people to use derivatives. It is just curious to me, though, that you are willing to take such a pronounced interest risk back that you only have the cash markets available to you and you don't buy caps or floors. When rates go up, and should they stay up, you can only hide behind GAAP accounting for so long. You can just look at the thrift industry in the 1980s to see what happened there. So it concerns me that there are so few institutions using derivatives.

The end-user line being flat, I think that speaks to that: (1) not many banks use them, and, (2) they are hedging the short term and rolling it over. The prospect of FASB 133[16] coming out does not bode well for either of those two concerns that I have: (1) long-term hedging, and (2) getting more firms to better manage their risk through all tools available, including caps and floors.

16. ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, Statement of Financial Accounting Standards No. 133 (Financial Accounting Standards Bd. 1998) [hereinafter FASB 133].

DERIVATIVE LITIGATION AND DISPUTE RESOLUTION

PROF. FELSENFELD: The next, and the longest, portion of our program has to do with derivatives litigation. I am very proud to introduce the next speaker, who will manage this afternoon's program. He is one of the acknowledged stars of the field of derivatives, helped create it in the 1970s, and now stands at its head.

Denis Forster, a New York lawyer, has been involved in some of the major derivative lawsuits. He served as lead counsel to the Kingdom of Belgium Ministry of Finance in its dispute with Merrill Lynch and advised Procter & Gamble in its highly publicized litigation with Bankers Trust.

He participated in the drafting and development of the 1987 and 1992 ISDA Master Agreements, and coordinated the amendment in 1994 of the New York Statute of Frauds making oral derivative trades enforceable. He established a practice in New York in which he largely consults and advises derivative end-users in resolving their disputes with dealers.

Denis, we are very happy to have you here and I turn the afternoon session over to you.

DENIS M. FORSTER:* Thank you very much, Carl. As you can see from your program, after my comments we are going to have the benefit of three different panels. We are very fortunate to have leading attorneys from the top firms here in New York who worked on recent derivative litigation cases, and they will be able to share with all of us their insights.

Just to keep them honest, we have Carolyn Jackson, who spent a number of years in the industry—in fact, I have known Carolyn for about twelve to thirteen years. After rising to the heights of being Executive Director of the International Swaps and Derivatives Association, Carolyn got religion and is now going to law school, as you may know. The real good news for Carolyn is that she has already landed a job with the prestigious firm of Allen & Overy over in London, so she is going to carry on her career.

And then, what is really going to be unique about this program

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is that we are going to have the benefit of hearing from the people who really count, the judges—Justice Ramos and Judge Hellerstein.

After my remarks, Martin Bienenstock and his panel will discuss unique issues of OTC derivative disputes. Then John Lovi and his panel will delve into litigation surrounding the sale of derivatives to funds. Finally the judges will share their perspectives.

I appreciate that there may be some here who do not have a whole lot of familiarity with derivatives, and it might be helpful if I start by identifying what part of the derivative world we will be speaking about this afternoon.

I guess, if you are going to divide up the universe, one way of doing it is to look at those instruments that are exchange-traded compared to those that are traded over-the-counter. Examples of exchange traded instruments are futures and options. In the United States, that is principally in Chicago. These are basically standardized contracts with margin requirements, a clearinghouse, and thus a lot less credit risk—almost no credit risk.

In sharp contrast with that, we have the over-the-counter ("OTC") derivatives. These would be swaps and options on a variety of different things, such as interest rates, currencies, commodities, equities, and now credit derivatives and others. These products are individually tailored and very, very innovative. There is no clearinghouse and often no security. They have the potential for a lot of risk, and therefore a lot of loss. Their trade association is the International Swaps and Derivatives Association that I just mentioned with respect to Carolyn.

We will be talking about OTC derivatives. In that context, the world can be divided with respect to participants into two different groups. On the one hand, we have those top-tier banks around the world, both commercial and investment banks, with a few affiliates of top-tier insurance companies, who have created a market in these products. We call them, as you may well know, in industry parlance "dealers." They sell products to those who can use them for purposes of risk and asset management. This might be corporations or it could be other banks, regional and community banks, pension funds, perhaps a whole host of other types of entities, including now individuals. We call them "end-users." So just to keep it clear, I will try to use that terminology throughout.

By the way, as Carl in his generous comments at the outset mentioned, and I should mention to you up-front so that you can properly discount whatever I have to say because of my biases, I do exclusively represent end-users. I appreciate that there may be some out there in the dealer community that basically equate any lawyer who represents an end-user as equivalent to the lawyer who might represent a child molester—or maybe even worse, the child molester himself. I appreciate that, because a lot of times these issues are real hot-button types. It's the one thing that I have seen people, particularly on the dealer side, actually get quite emotional about. We are going to try to keep it real dispassionate here, of course.

I should mention in this regard two things. I am not going to try to say that even end-users deserve legal representation, because I am sure you all would agree with that. But what I want to say is that there are indeed end-users out there who, with their eyes wide open, go out and bet on black and it comes up red; then they go groping around trying to find a legal excuse to wiggle off the hook, a legal loophole. Since this is what I do exclusively, I do get calls from those types of end-users, and they are usually not those that have been in the market for a long time. I think that I know the right questions to ask and I am pretty well able to screen them out quickly. I decline much more business than I accept. Believe it or not, there are some end-users out there that have a meritorious case, and that is what I want to talk about today.

But also, as a second point, I want to mention that it is difficult in many respects to represent the end-user. In a sense, the deck is stacked against you. I have been trying to remember that expression that John McCain has been using—and over-using—which has to do with "Star Wars" and he is battling against all these "known evils." Anyway, it is some figure from "Star Wars."

I am not going to suggest to you that representing the end-user is that difficult, but there are a lot of forces that you have to reckon with. The main one is that we are a Johnny-come-lately. When as a lawyer you get involved in a dispute, the die has already been cast, in a sense. The deal has been done, the documentation has been done, the end-user has signed on the dotted line, and the documentation may be very disadvantageous, and there may be a number of other things that are going against you. I will talk later about how one could help balance the playing field, an opportunity that counsel for the end-user does have to balance the playing field. But starting off, it is definitely tilting against you.

In terms of putting some kind of perspective on this thing, we have the end-users and the dealers, and I am very, very happy to say that, in general, they live in harmony. When you look at it, it is only a small fraction of one percent of the deals that end up being disputed. Usually, however, the amounts are so enormous, the losses so huge, that it overshadows the positive contribution being made by dealers with these instruments. But it is a reality that in fact it is a very, very small fraction. It is that fraction of deals that go awry that have given the industry some pretty tough times.

What I would like to do is talk about a couple of cases that were high profile, and try to put them into some kind of perspective. What impact have they had on the industry and the industry's way of thinking? Then I would like to go through a number of causes of action, or theories of recovery, that end-users' counsel should have on their checklist. Perhaps counsel representing the dealers will want to have on their checklist in terms of structuring deals properly and documenting them properly at the outset. Finally, I would like to talk about some strategic considerations that end-users' counsel should use.

Now, the date was September 12, 1994. That was a date that an event occurred that rocked the OTC derivative markets, and things have really never been the same since. On that day, a lawyer named Cliff Craig, of the Cincinnati law firm of Taft, Stettinius & Hollister, walked into Federal Court in Cincinnati and filed a complaint against Bankers Trust on behalf of his client, Gibson Greeting Cards.[1]

I remember the date quite well and the immediate aftermath. The reaction of the industry was furious. The basic thought was, "How can they do this? How can people who enter into a trade seek to unwind it by getting lawyers involved using legal loopholes?" Gibson Greetings was asking to basically void a

1. In re BT Securities Corp., Securities Act Release No. 33-7124, Exchange Act Release No. 34-35136 (Dec. 22, 1994) (concerning a "Treasury-Linked Swap" between Gibson Greetings and BT Securities Corporation).

number of trades with a marked-to-market value of $23 million.

Then the all-important facts started to seep out. The SEC got involved, they investigated, and they got hold of some tapes. The pattern and the facts that emerged were that Bankers Trust had gone in and entered into a series of increasingly sophisticated, increasingly complex, increasingly risky transactions with Gibson Greetings, culminating in a LIBOR-squared swap. Nobody had ever heard of a LIBOR-squared swap before.

When you looked at it, really what had happened was that Gibson Greetings, a gift-wrap and greeting cards maker, in Cincinnati, Ohio, had written an option in favor of Bankers Trust to pay Bankers Trust LIBOR-squared times the notional principal amount if LIBOR breached a certain barrier. Again, I have never heard anybody who could economically justify such a trade, except perhaps to earn premium income for Bankers Trust.

And then there were the tapes. It became quite clear from the tapes that Bankers Trust had identified a pigeon at Gibson Greetings and were feeding him some erroneous information with regard to value.

The reaction of the industry was, "Well, maybe in this particular instance one of our own crossed the line. Maybe Bankers Trust shouldn't have sold a LIBOR-squared swap to this greeting cards maker in Ohio." That was on September 12th.

Meanwhile, back in Cincinnati, cross-town swap loser Procter & Gamble finds that it is sitting on top of trades which amount to $200 million marked-to-market engaged in with the same crowd from Bankers Trust. As you might imagine, the *Cincinnati Inquirer* and all other papers had headlines about what happened to Gibson Greetings, so Procter & Gamble filed its suit in Federal Court in Cincinnati, Ohio.[2]

Gibson Greetings alleged a number of counts, including breach of fiduciary duty, fraud, and Procter & Gamble did essentially the same thing. Later they also alleged a RICO count. There were some sixteen different counts that Procter & Gamble alleged in that particular case.

The case eventually settled about eighteen months later, in

2. Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996).

May of 1996, and simultaneously two things happened. First, Judge Feikens issued an order and a reasoned decision dealing with a whole host of counts raised by Procter & Gamble. But, before that order had been delivered by Federal Express to the parties, the parties settled the case, and they settled the case in a manner very favorable to Procter & Gamble. Basically, the $200 million liability, more or less, to Bankers Trust was reduced to $35 million and there were some adjustments made on swaps. In other words, a very, very positive settlement for Procter & Gamble.

What was important there was that Judge Feikens went through and he slammed the door shut on about thirteen different counts that Procter & Gamble was trying to get to the jury. But he left one door open, and all you need is one door. That door was the concept that if one party has superior knowledge not readily available to the other party and the first party knows that the second party is acting on a mistaken belief, then that first party—read that Bankers Trust—has a duty to disclose material facts, and a failure to do so with intent and the other elements necessary for fraud, constitute a fraudulent omission. I wrote an article which goes through the decision by Judge Feikens and focuses on a number of the different things that he said that may be of some interest to you at some point in time.[3]

Now, what was different about these two cases? Why did I say that this rocked the OTC derivatives world? Well, before this happened, most of the cases involving OTC derivatives involved an insolvency. In fact, people that talked about derivative litigation didn't have too much to talk about; you could get it done in about a half-hour.

There were two cases involving California thrifts, there were a couple of cases involving Drexel, and then there was the *Hammersmith and Fulham* case in England that I will talk about shortly. However, in each of those cases the common denominator was that you were dealing with an insolvency, or if the trades were upheld, you would have had an insolvency.

People at that point in time looked at the two major risks in

3. DENIS M. FORSTER, AN ANALYSIS OF THE HOLDINGS IN *PROCTER & GAMBLE V. BANKERS TRUST* (2000) (on file with the *Fordham Journal of Corporate & Financial Law*).

derivatives. First, let's say we enter into a trade and the market moves against us. The market is either going to move for us or against us, and the market moves against us. Well, we call that market risk.

But what if the market moves in our favor? That is the good news. But what's the bad news? The bad news is our counter-party doesn't pay us. So we had counter-party risk. Prior to 1994, most people in this business equated counter-party risk with credit risk, credit risk being the financial inability of your counter-party to perform, because it is insolvent for instance, or near insolvent. That makes sense. That is credit risk.

But people really didn't focus on this other thing, called legal risk. When Gibson Greetings and Procter & Gamble filed, what they were saying is, "We've got the financial ability to pay, but we are mad as hell and we've got a legal reason not to pay, so we are not going to pay." And there is the difference. Now people started to say, "Hey, you know, there is this thing out there called legal risk. We really never focused on it, but maybe we should start focusing on it."

Now there is so much derivative litigation out there that Andrews even has a *Derivative Litigation Reporter*.[4] You know that your field has arrived when Andrews trots out a Litigation Reporter. So there is a lot of litigation. We have people here appearing on the panel dealing with these issues, but some years ago people really didn't focus on these points.

I would like to take a brief trip through the different causes of action that have been used, alleged, and talk about the legal risks associated with those. I think they ought to be on a checklist for end-users' counsel, and even for counsel representing the dealers.

The first, in terms of a logical sequence, would be to deal with capacity, because after all, what we are usually talking about here is trying to enforce a contract. In basic Contracts 101, we learned

4. In 1970, Andrews Publications created the first Litigation Reporter and revolutionized the delivery of timely and accurate litigation information. Currently, Andrews publishes over 50 Reporters covering key legal niches, including the Andrews Derivatives Litigation Reporter. The Derivatives Litigation Reporter, published in 24 issues per year, provides summaries of over-the-counter derivative controversies in cutting-edge cases. See generally <http://www.andrewspub.com>.

in the first day that the party with whom we are contracting has to have the capacity to contract. For instance, a minor does not have the capacity to contract except for necessities.

We know that, in the United States at least, when we are talking about corporations, the idea that they can turn around and claim lack of capacity has pretty much gone by the wayside. In fact, under Delaware General Corporation Law, there is a specific provision that says that a corporation cannot use lack of capacity as a defense except in certain very limited circumstances not relevant here.

So if you are dealing with a U.S. corporation, you generally do not have to worry about this one. But there are others you do have to worry about—particularly, municipalities, pension funds, and regulated industries. Also if you are dealing with an offshore entity you may have to worry, because what applies here in the good old U.S.A. may not apply offshore.

Perhaps the most famous case here was *Hazell v. Hammersmith and Fulham*,[5] a borough in London. There, from 1983–1989, the borough went out and dealt with some eighty different commercial banks and put on literally hundreds of trades all betting that Sterling short-term interest rates would remain low. They were right until 1989, when Sterling short-term rates spiked. When they spiked, the borough's auditor took a look and said, "You know, I'm not so sure that these contracts are enforceable because I'm not sure we have capacity here." Of course, they had been accepting the money for some six years.

The long and the short of it is that the case went to the House of Lords and, in a unanimous decision (5–0) in 1991, the House of Lords looked at the authorizing statute, which dated back to 1845, was amended in 1972, and said, "You know, we can't find anything in here that says that this borough can do swaps and furthermore, these were not incidental to their borrowing powers; therefore, commercial banks, these contracts amounting to over $500 million are void." That got a lot of people's attention. So we had the capacity issue there. The first thing to do is to check capacity.

Also, the same issue of *ultra vires* was raised in the Orange

5. Hazell v. Hammersmith & Fulham London Borough Council, 2 All Cas. 1 (1991) (on appeal from Q.B.).

County case with regard to the reverse repurchase agreements. Arguably these agreements exceeded the restrictions imposed by the California Business Code. If so, they would have been rendered them void.

Then there is the related but distinct issue of authority. In addition to *ultra vires* and capacity, we have the issue of authority. The issue is that the entity has the capacity, but does the particular individual signing have the authority. In the United States and other common law jurisdictions, what usually bails us out here as a failsafe is the doctrine of apparent and ostensible authority. We have had a lot of rogue traders around the world, such as Nick Leeson[6] and the like. But until recently, I hadn't heard of a bank or a counterparty or anybody turning around and saying, "You know, the doctrine of apparent authority doesn't work because you knew our guy didn't have the authority"—until recently, in the *Sumitomo Copper* cases.[7] That is now being alleged by Sumitomo Copper.

In other words, the idea here is—and this is important in this business, which is basically done by telephone—that if the company arms an individual with a telephone and puts him in a position of ostensible authority, then that entity is going to be bound regardless of the fact that maybe he or she does not in fact have authority.

Where this can come up overseas, when you move away from the common law jurisdictions to civil law jurisdictions, is you have to fall back on express authority. There can be some pretty bizarre things out there. In some countries, a person is authorized only if their name appears on the registry, and the registry may only be open between 10:00 and 2:00 on Tuesdays, and it is very difficult to know whether or not you are in fact dealing with someone who is authorized. I guess, in a couple of instances, counterparties have

6. Nick Leeson is a former derivatives trader with Barings Bank, Britain's oldest financial institution, who caused its collapse by making certain trades that exposed Barings to excessive risk. *See* Richard W. Stevenson, *The Collapse of Barings: The Overview, Young Traders' $ 29 Billion Bet Brings Down a Venerable Firm*, N.Y. TIMES, Feb. 28, 1995, at A1. *See generally* BANK OF ENGLAND, REPORT OF THE BOARD OF BANKING SUPERVISION INQUIRY INTO THE CIRCUMSTANCES OF THE COLLAPSE OF BARINGS PP 1.33-1.70 (1995).

7. *In re Sumitomo Copper Litigation*, 74 F. Supp. 2d 393 (S.D.N.Y. 1999).

raised that as a defense. It seems like arguably a low blow, but there it is, and it is something that people have to be alert to if they are dealing offshore.

The next issue I would want to bring to your attention is the Statute of Frauds. Again, we are going back to Contracts 101. Hopefully, nobody skipped Contracts 101, because there is a lot in it. You may recall that at the time of Charles II, in order to avoid a variety of different frauds that were then being perpetrated in England after the so-called civil war over there, they passed the Statute of Frauds.

One of the provisions was that an oral contract which by its terms cannot be performed within one year—sort of archaic language, which we picked up and have in our statutes today—is void. So you take a look at a trade, let's say, a swap that goes out thirteen months that is done orally over the telephone. Do you have a deal? Well, not unless you have done something about the Statute of Frauds.

And again, what makes this so important for historical reasons and for practical reasons in this business is basically "trade now, document later." The vast majority of these trades are done orally over the telephone with the expectation, at least by the dealer, that it's a done deal when they hang up the telephone. Now, in 1994, New York changed the Statute of Frauds with regard to the one-year rule.[8]

Also, I forgot to mention that we have had two cases here in New York, *Intershoe v. Bankers Trust*[9] and also *In re Koreag*,[10]

8. In 1994, the NY Legislature added a new subdivision (b) to General Obligations Law 5-701. This subdivision provides that a qualified financial contract, defined in subsection (b)(2), would not be subject to requirements that a writing (as defined in the statute) be present, so long as there was sufficient evidence of a contract or if the parties agreed by a written contract (before or after the contract in issues) to be bound by telephonic or electronic messages or other means of agreement. Generally, the 1994 amendment sought to release large broker-dealers from the NY Statute of Frauds writing requirement when they conduct certain types of transactions with qualified institutional investors. *See* N.Y. Gen. Oblig. Law 5-701(b) (McKinney Supp. 1997).

9. 77 N.Y.2d 517 (1991).

10. Koreag Controle et Revision S.A. v. Refco F/X Associates, Inc. (In re Koreag, Controle et Revision S.A.), 961 F.2d 341 (2d Cir. 1992) *cert. denied*, 506 U.S. 865 (1992).

where courts here in New York took the view, supported by the official commentary in Article 2 of the Uniform Commercial Code, that foreign exchange and foreign currency are goods; therefore, a sale of a foreign exchange contract is a sale of goods subject to Article 2. If you follow that and take it just one step further, that means that any foreign exchange contract for over $500—meaning 99.9 percent of them all—is subject to the Statute of Frauds. In 1994, New York changed that, as well.[11]

But what I think people need to be alert to is that although New York has changed the application of Article 2, other states have not. Therefore if, for instance, you have General Re or AIG up in Connecticut dealing with someone in Texas, or even someone here in New York dealing with someone in Texas, what is the applicable law?

There may be a Master Agreement in place—and this sort of gets intricate—and there are provisions of Master Agreements that say all agreements have to be in writing. If you follow that, you sort of block the protection of the Statute of Frauds. In any event, it is something that I think people need to be alert to.

Moving on, another count frequently raised in these cases is misrepresentation. This is a fact-intensive inquiry. Basically it is whether or not the facts of the particular case match up with the elements for misrepresentation under New York law.

And then, there is the one that has drawn an awful lot of attention, as I alluded to earlier, which is fraudulent omission, also known as fraudulent concealment. Here, Judge Feikens in the Procter & Gamble case, as a Michigan judge sitting by designation in Ohio in a case in diversity, but applying New York law, looked at New York law, and said that under New York law there is a duty to disclose if any of those three conditions that I earlier mentioned occurred. That is to say that if Bankers Trust had superior knowledge as to material information not readily available to Proctor & Gamble and knew that Procter & Gamble was acting on a mistaken belief about that information, there is a duty to disclose the information.

If those things come together and coalesce, then a duty to disclose occurs and the failure to disclose can constitute fraud. The

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11. *See* N.Y. Gen. Oblig. Law 5-701(b) (McKinney Supp. 1997).

benefit from the standpoint of an end-user here is, with either misrepresentation or fraud, it could lay the basis for entitlement to punitive damages.

Next is fiduciary duty. That is, admittedly, a difficult one to establish. In fact, basically Judge Feikens said in *P&G*, "Hey, you guys don't need fiduciary duty. Quit coming at me with that one. You've got superior knowledge and that should get you home." That is basically what he said, reading between the lines.

But under fiduciary duty what one would have to establish is that: 1) the dealer invited the trust and confidence of the end-user; 2) the end-user placed his trust and confidence in the dealer; and 3) because of that trust and confidence being placed, the dealer had a position of superiority and influence.

When you use the word "fiduciary" it is like using RICO.[12] Sometimes the titles just don't match. We talk about RICO, and RICO seems to be used against everybody except racketeers. We are sort of hampered, in a sense, by the label "fiduciary duty" because it sounds so awesome. But if you ask a dealer and a salesman, "How do you get the business away from your competition? How is it that you were able to sell this product and all the competition trying to get at that end-user couldn't do it?" They might very well say, "Well, I got the trust of that customer."

A lot of times when you are dealing with explosive products, such as derivatives, like nitroglycerin, the person buying the product wants to be able to trust the other party. So whereas at first blush it sounds like a far stretch to say that the dealer has a fiduciary duty, when you look at the facts, and you find a great disparity in knowledge and sophistication between the parties, then it becomes, I think, much more acceptable.

There are a number of others; I will just mention them:

1) Federal securities laws, in particular, Rule 10b-5.[13] The

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12. 18 U.S.C. §§ 1961-68 (1994 & Supp. II 1995).

13. See 17 C.F.R. 240.10b-5 (1999). Rule 10b-5 under the Securities Exchange Act of 1934, first promulgated in 1942, was adopted in order to prohibit any person from using or employing any manipulative or deceptive device in connection with the purchase or sale of a security.

> It now reads: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to

threshold issue there is, whether this particular instrument constitutes a security for purposes of the federal securities laws.

2) The anti-fraud provisions of the Commodity Exchange Act.[14] There, the threshold question is, whether the instrument is a futures contract or a commodity option, so as to bring into play the protection of the Commodity Exchange Act.

3) You might also want to take a look at state securities laws. In a particular state, there may well be protection, again if your instrument constitutes a security.

4) I almost hate to mention this one, and would never run a case based on this alone, but you might use the gambling and gaming statutes, particularly offshore. We have pretty much resolved that problem here in this country, but you may find that there is some merit there. Again, I would use this as an add-on. I would never try to use this as the sole basis for a defense of an end-user.

5) There is, as I mentioned, the RICO Act[15], which some people use, and I think should be used very, very sparingly and only if the facts scream out for such a thing, but in some cases maybe they would.

6) Last but not least, what I suggest should be on people's checklist are the anti-tying provisions of the Bank Holding Company Act[16], which were adopted in 1970. The provisions are almost counter-intuitive, basically saying that one cannot tie one product to another product in a sale. But an aggressive salesman, the same person who is selling that derivative, may very well overstep the boundaries here and tie the two products together. You can also theoretically make out a case under the Sherman

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> employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact in order to make the statement made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

14. 7 U.S.C. § 1 et seq. (1994).
15. 18 U.S.C. §§ 1961-1968 (1994).
16. 12 U.S.C. §§ 1841-1841 (1994).

Act, but that is a near-impossible task with the requirements for affecting interstate commerce. But the Bank Holding Company Act is really fairly easy and streamlined if you have the facts and if you are dealing with a commercial bank or one of its affiliates.

There may be some others, such as the Unfair Trade Practices Acts under the states, but those are the major ones.

Now, what do we do about this? I talked earlier about how the end-user is in this inferior position because of his knowledge of the product—and by the way, the products we are talking about are not "plain vanilla." The ones that blow up and cause problems are the ones that are very, very complex. Marketers do not make a lot of money by selling "plain vanilla" swaps. They are like commodities with very, very narrow margins. Where they make the money is with the complex products, which are difficult to value, difficult to price, or at least difficult for the end-user to determine the appropriate price and the actual risk level.

To start off, you are going to find that your client pretty much has no idea as to the workings of the product, how to model it, how to price it, what the alternatives were in terms of market practice. Further, the client will have signed some documentation without really having even read ISDA.

How many people are out there in, for instance, the oil patch down in Texas, doing these trades, signing ISDA agreements that never read those ISDA agreements, much less understand them? I think you could take 100 and you wouldn't find one.

Now, I have the good fortune of having only one client for transactional work and I try to reserve the rest of my time for representing end-users in disputes. That client is Microsoft Corporation. They are a wonderful client in many, many respects. They are not a triple-A-rated entity. Despite all of the problems they are facing right now in terms of legal challenges, they are nevertheless a very, very attractive counterparty for dealers. Dealers are very anxious to do business with them, even though they don't have a triple-A debt rating. The reason they don't have a triple-A debt rating is they don't have any debt. In fact, they are sitting on $19 billion of cash. Now, that makes it pretty easy in dealing with dealers and negotiating with dealers' documentation. At the end of the day, I think we get some very protective documentation from dealers.

Now, the irony of this is that Microsoft's treasury is staffed with a number of very bright people who probably don't need the protection that I negotiate for them. But the people that really need the protection are the ones that are maybe doing one or two deals. They often do not have the protection.

I am going to turn next to what we do about these things. What do you do about such a situation? We all look at the world through a different knothole, and because we stand in different places we see different things. Here in New York, quite understandably, finance and commerce is king. To us, the sanctity of the contract is very, very important. We frequently say, "If you sign it, you should have read it; if you read it, you should have understood it; if you didn't understand it, you should have gotten a lawyer." That makes a lot of sense right here in Manhattan, and we can understand why the law is the way it is in New York.

But I suggest that if you take that same scenario down to Texas and ask a judge to look at the situation and say, "Did it really make sense in this fast-moving environment to ask this assistant treasurer to go up to New York to try and find somebody that knows this stuff, that has the time to work on it and figure it all out and negotiate it and pay him those New York rates that the lawyers charge up there before doing the deal; or, alternatively, just accept what the dealer said was standard documentation?" I think you might find that the Texas judge says, "You know, you are right. I think I can find an ambiguity in this twenty-four-page document which will help you out." So it is just a difference in viewpoint.

So the question here is, how do we balance the playing field? I think it is through the choice of forum. In the ISDA Agreement Section 13-b, it basically says that if you select New York law, you get New York jurisdiction. Nobody ever changes that, or they very rarely change that. So you can have the emphasis on non-exclusive jurisdiction.

The alternative—and you look around and you say, "Well, under the facts of the case, would I have jurisdiction in our home state?"—let's just use Texas as an example. Then you look at the long-arm statute in Texas, you find that perhaps the dealer came down and made calls in Texas and did a number of other things to satisfy the minimal requirements of the due process clause and the long-arm statute. Now you say, "Well, I can sue them in either Texas or New York." Which way are you going to go on that one?

And if there is any question about it, you might want to think back to what happened in the *Pennzoil v. Texaco*[17] case back in the 1980s. In that case, Pennzoil did not come up to White Plains to sue Texaco in New York. They sued them in Houston, in Harris County. There the jury got hold of this one and came back with a $10.2 billion judgment against Texaco. Texaco felt it had some strong grounds for appeal—but guess what? They could not appeal. The reason they could not appeal is they had to file an appeal bond. The appeal bond was twice the amount of the judgment. They could not get anybody to come up with an appeal bond for $20.4 billion. So what happened? They had to settle. They actually went into bankruptcy. They were driven into bankruptcy and eventually settled. As sort of a footnote to that, plaintiff's counsel down there, Joe Jamail, according to *Forbes*,[18] was compensated for his efforts in that case to the tune of $345 million and is now one of the wealthiest people in America. But getting back to the forum issue, the interesting point is that initially somebody from Pennzoil filed up in Delaware. Then they realized their mistake and, before Texaco responded, they were able to get a dismissal without prejudice and get it back down into Harris County.

It is not only the juries that people should give some thought to. I would like to share with you one story about the late Carl Rubin, who was the presiding judge in the *Procter & Gamble* case in Cincinnati, who very unfortunately died in the midst of that case. He was a very highly regarded individual. I understand that he had a canned speech that he would pull out every time a New York lawyer walked into his court. The thrust of that speech was he was going to raise that New York lawyer up to the level of a Cincinnati lawyer. So it is not only the jury, but also maybe the judge is a bit different and creates a different environment.

So in terms of which way to go, it is hard to imagine, at least domestically, if you are representing somebody in the United

17. 626 F. Supp. 250 (S.D.N.Y. 1986).

18. *The Forbes 400: America's Richest People Renegades*, FORBES, Oct. 11, 1999, at 362.

States and you have a choice to sue in Texas versus New York, why you would ever sue in New York. Now, never say never, and there may be a reason I just haven't thought of.

Of course, people feel much more comfortable in their own jurisdiction. Procter & Gamble, as an example, didn't file in New York. I don't think the thought ever occurred to them. In 1840, when Cincinnati was just a cow town, two guys named Procter and Gamble went down to the slaughter yards and took the fat off the carcasses of the cows, started making soap, and now you have a $31 billion-a-year company. Along the way, they had given a lot of money to local orphanages and universities and the like, and they are known as a model corporate citizen. Where are they going to go? Are they going to look for a jury in New York or in Cincinnati? That should be pretty easy.

In representing the end-user, I think one should make sure that they guard and protect the ability to sue in the local forum. If there is money due under the contract, you want to make absolutely certain that you don't breach it. You don't want to say anything that would constitute an anticipatory breach so that you can retain that.

Now, wanting to close on a positive note, what makes sense in these cases? Carl and I were talking earlier about all of these cases settling. These are not about great principles, like abortion and things like that. This is about money. Also, the reality is that the dealers are good companies with good culture. A lot of times, what happened is that a bonus-oriented salesman got off the reservation and did something that maybe senior management isn't too happy about. So there should be an opportunity to settle, and there will be at some point in time.

The question is, when do you settle the case? The time that seems to make the most sense in these cases is before filing the complaint. I say that because there is settlement value to be extracted. The dealer does not want the complaint to be filed for two reasons:

- One, negative publicity, if indeed you do have a case that involves negative publicity—and I am assuming all along that we've got a meritorious case. Publicity is important particularly if there are tapes and sound bites and things that the press would get hold of. It is what the federal regulators call reputational risk. So the dealer is not going to want that to happen.

• And also, there is the concern in some cases by the dealers of copy-cat cases. For instance, when Gibson Greetings started with their case, then you had Procter & Gamble and Air Products and Federal Fiberboard and Sandoz AG, and everybody is coming out of the woodwork. So dealers know filing can have that effect, and this can get worked into the settlement amount that is provided.

On that happy note, I would like to close.

ISSUES UNIQUE TO OTC DERIVATIVE DISPUTES

MS. JACKSON: It is my great pleasure to introduce the first panel of lawyers discussing litigation concerning derivatives. In particular, we are going to be looking at the issues that are unique to over-the-counter derivatives. As Denis mentioned, there are generally three broad categories: derivative securities, derivatives as futures, and then over-the-counter, privately negotiated transactions.

I also want to introduce the moderator of our panel, Martin Bienenstock. Martin is a partner at Weil, Gotshal & Manges, and he is in the Business, Finance, and Restructuring Department. He has represented debtors, creditors, and investors in restructuring troubled companies in and out of Chapter 11.

Also, I can't really refer to derivatives as cases or losses, so I want to say that he was representing Merrill Lynch in the Orange County "derivative situation."[1] In particular, when he is discussing over-the-counter derivatives, he is going to be looking primarily at the issues that are unique to bankruptcy.

Basically Martin, I would like you to say a few words and I would like my fellow panelists to say a few words as to why they are here, assuming you know.

MARTIN BIENENSTOCK:* Carolyn, you summed up why I am here, so why don't I just introduce David Brower and Aaron Rubenstein? They can say who they are and then you can start your presentation.

AARON RUBENSTEIN:** I am a partner at Kaye, Scholer, Fierman, Hays & Handler. I have been involved in derivatives litigation for quite some time. I do not like to characterize myself as a either dealer or end-user champion. I have represented both sides.

I guess perhaps the case that some of you may be most

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1. County of Orange v. Merrill Lynch & Co. (*In re County of Orange*), 191 B.R. 1005 (Bankr. C.D. Ca. 1996).

*Partner, Weil, Gotschal & Manges LLP; Counsel for Merrill Lynch & Co. in County of Orange v. Merrill Lynch.

**Partner, Kaye, Scholer, Fierman, Hays & Handler, LLP.

familiar with is an end-user representation. It involves a lawsuit between what is one of the largest state-owned companies in China, called Minmetals, against Lehman Brothers in connection with a number of different types of derivative transactions. It presents some issues that, of course, cover the waterfront that Denis mentioned—suitability, fiduciary duty, and the like—but also focuses on issues that are perhaps not as often found in cases, such as authorization and legality. I will be trying to focus for a few minutes on those.

DAVID A.P. BROWER:*** My name is David Brower. I am a partner with the firm of Wolf, Haldenstein, Adler, Freeman & Herz. Unlike most of the people on the panel, I represent only end-users, and those end-users are typically individual investors. With respect to derivatives, they tend to be very wealthy individual investors or family accounts, and many of the strategies I have heard today are ineffective for them.

I am going to be talking about suitability, the paradigm we have seen over the last ten or fifteen years. We see about one case a year—or, at least, somebody comes to us about one time a year—in very similar circumstances. About half of the time, they are foreign investors who have invested with American banks or multinational banks and have gotten into serious trouble because of cyclical turns in the underlying securities from which derivatives were sold. The situations are amazingly similar in each of those situations. In most of those situations, the investors have been recompensed, because most litigation settles, as you know. But in cases involving the sale of derivatives, suitability cases are somewhat better suits, as are churning cases, than the normal broker-dealer situation when people are trading stock.

I will be talking about the kind of situations we see and the kind of things that—I will call them "brokers," rather than dealers—do, the problems the firms face, and the problems the investor faces when confronted with them. Specifically, I will talk about what happens with margin calls: how much time investors are given, what kind of explanations are given, and then what happens to their investment portfolios in relatively short periods of time, usually minutes, when they are left holding the bag.

***Partner, Wolf, Haldenstein, Adler, Freeman & Herz.

MS. JACKSON: Thanks. Basically I can give my disclaimers. I am going to be speaking about a transaction involving a tobacco company by the name of *Sociéte Nationale D'Exploitation Industrielle des Tabacs et Alumettes* (SEITA) and Salomon Brothers, in particular, Salomon Brothers International Limited (SBIL).[2]

At the time, I was working at Cravath, Swain & Moore. I was brought in, not because of my legal knowledge, not at all, because most of you now know that I had just completed my first year of law school here at Fordham. I was basically looking through the portfolio.

I wanted to talk about the case because I think it kind of sets the guidelines here, because the facts are pretty typical and the story is pretty typical about why a counterparty would sue. In particular, I am very privileged to have Judge Ramos here, because he rendered the Supreme Court decision which ruled in favor of SBIL. The appellate court decision, which also upheld the verdict for SBIL, came out on January 25th, so it is relatively fresh.

PROF. RECHTSCHAFFEN: Carolyn's PowerPoint presentation is a handout also. So if we are unable to overcome the technical difficulties—and, Denis Forster, who is Microsoft's attorney, take note of this.

MR. FORSTER: I thought we were friends, Alan.

PROF. RECHTSCHAFFEN: If we are unable to overcome that, you can follow Carolyn's presentation with the handout that says "PowerPoint Presentation Presented by Carolyn Jackson."

MS. JACKSON: I am very sorry about this, because over the years of being a derivatives trader I have gotten very good at PowerPoint presentations, and at having boxes and arrows fly in and fly out and checkerboards. So you are going to miss that, but I think we will all live.

Basically, the first slide presents the players. As I mentioned before, SEITA is a tobacco company in France, but at the time—and this is fairly important to note—it was owned by the government. Because of the way the tax system works in France, they were allowed to hold the tax revenues for about a year, which

2. Societé Nationale D'Exploitation Industrielle des Tabacs et Alumettes v. Salomon Bros. Intern. Ltd., 702 N.Y.S.2d 258 (N.Y. App. Div. 2000).

gave them a fairly sizable cash portfolio to manage. Likewise, you should be aware that SEITA generally bought tobacco in the United States. Japan was one of the places that they sold their tobacco products. Furthermore, quite often a lot of SEITA's borrowings were in Deutsche marks.

Around 1994, they entered into two transactions with Salomon Brothers. They are basically swaps transactions. And again I am sorry, as a trader, I cannot even think about doing a swap transaction without drawing the pictures.

The way the first trade worked is that Salomon Brothers was to pay a fixed percentage on the notional principal amount to SEITA for every single day that the Deutsche mark LIBOR rate—the floating rate of LIBOR that is paid in dollars, but it is pegged to the Deutsche mark Inter Bank Offer Rate, not the U.S. Inter Bank Offer Rate—remained within a specified range (a cap and a floor rate). Basically, you would look every day and say, "Gee, did Deutsche mark LIBOR fall within this band?" If it did, then Salomon Brothers would make a payment. If it did not, SEITA would get zero. It is a pay out structure.

Then, at maturity, the number of days that Deutsche mark LIBOR was in the range would determine the pay out. Now, the reason why it was in a band—remember, they needed to protect themselves against Deutsche mark rates rising—but they had a band because often it is cheaper to get protection if you both buy and then sell off some of the up side. So you do not get the full benefit because you sell it off, but it makes your protection on the downside cheaper.

So basically, Salomon Brothers is paying for every day that the Deutsche mark LIBOR falls within the range, and then at maturity, SEITA was to pay $35 million. If you actually did the math and cranked out the number of days that the Deutsche mark LIBOR rate could have been within the band, SEITA could have made a fair bit of money at the end of the trade.

Likewise, on the second trade, it was $15 million that was going to be paid at maturity, but now instead of pegging the pay out to the Deutsche mark LIBOR rate, the variable was the U.S. dollar/yen exchange rate. Again, this made sense for them as a company because, since they were buying U.S. tobacco, they needed to protect themselves against an appreciating dollar; and because they were selling in Japan, they needed to protect against a depreciating yen.

Then, unfortunately, life got a little bit more interesting for SEITA because they decided to privatize and go public. Incoming management said to all the dealers, "Give us our marked-to-market value of the trades."

And so, even though before the change in management, there had been a series of back-and-forth marked-to-market valuations—sometimes SEITA would call up SBIL and say, "Gee, where is my trade valued right now? Maybe we can restructure and move the trade out to a later maturity date." So there was this ongoing dialogue where various marked-to-market quotes were given for the two trades. Once the company decided to privatize, the trades were basically liquidated.

With the privatization, SEITA realized that they would have to pay roughly $30 million to SBIL. That was fine. They made the payment. Then, as the company spent more time looking at their derivatives portfolio, they brought suit in New York questioning the suitability of the two trades.

I am very glad Denis went through the main allegations that people generally bring, because there is absolutely nothing new in this story—breach of fiduciary duty, breach of the good faith implicit in contracts. Basically the idea—remember, those valuations, I was talking about, were going back and forth between marked-to-market—was that those valuations were misrepresented, and also that SEITA could not understand the risk from the way the trade was presented.

The usual lack of authority—and it was the treasurer of all of the SEITA dealing room who entered into these transactions. Since they had a large cash portfolio to manage, he was very active in the derivatives market.

And again, suitability. I have already gone through the steps of actually how these were hedges to the global portfolio, or certainly could be viewed that way.

And then, basically fraud and nondisclosure, the typical things, saying, "Gee, these trades were more complex, why didn't you share your models?"

And then, as I am pleased to say, on February 8, 1999, Judge Ramos ruled in favor of SBIL. But, as the story goes on, SEITA appealed. On appeal, they were really trying to get at what was going on with the valuations of the marked-to-market and some internal accounting records. One of the reasons for this is that the live quotes they got did not necessarily agree with the end-of-closing day marked-to-market valuations in the back office. But this is like an apple and an orange. SEITA lost the appeal as of January 25th.

I have already alluded to some of the reasons why accounting versus marked-to-market numbers can differ. End of day marked-to-market prices generally come from the 3:00 o'clock futures close and then, quite generally, the 5:00 Treasury close. And as you now know, quite often the Treasury market stays open. So even in your necessary yield curve, you have a two-hour discrepancy—an inconsistency along your curve.

The important thing, too, is that end of day prices are dead prices. Nobody was actually trading at those prices. Also, in terms of these transactions, they involved interest rate exposure, exchange rate exposure, and volatility exposure. That meant that the back office had to go get all these yield curves for the various variables.

I have to tell you, deriving a perfect volatility curve is like a nightmare. It can be a weeklong process because the options in people's portfolios can be so complex that you actually need to go out and call the brokers and say, "Try to get a price for me on this trade," and then they reverse-engineer what the implied volatility was on that price. So I am just saying that in the back office, the prices are very, very stale; whereas when you are quoting live—especially people on transactions—you generally have a spreadsheet all designed, they have live feeds coming from the data feed sources, they hit a button, and then, hopefully, they check it out with some internal models, et cetera, to make sure of what they are quoting. But it is quite a different thing.

Another big consideration is that in general, the back office marks to market at the mid point. If you are quoting a trade, hopefully, you are going to be on the bid or the offer side, so there has to be a discrepancy for that as well.

Also, back office is generally done in a batch at the end-of-day, and you cannot get the fine-tuned structures of the individual trade, so sometimes a little leg might be left off. And at a big year-end or quarter-end valuation date, all that will be reconciled. But in terms of letting the back office generate the reports about the overall risk, that level of detail being missed is okay. But if you are actually quoting on a trade, that can mean millions of dollars. So again, there is another reason why you just don't look at back-office numbers if you are quoting a live trade.

And quite often, some people have different models between the front and the back office. I know the regulators are now trying to say that we should have the same model for both front and back office. There used to be a period of time where some regulators actually preferred firms to use two different models, because it was a check and balance that kind of alerted you as to when something might be going wrong.

Also, even within their models, deriving the curves, just the slightest little change can make a big, big difference. People have big fights—I mean, I know this isn't something everybody wants to go home and fight about, but the derivation of the forward-yield curve: do you start with overnight LIBOR, do you start with one-week LIBOR, or do you start with one month LIBOR?

And then, we all know that the yield curve has a shape, but it usually has just two straight-line data points. Do you straight-line interp or do you cubic spline to kind of approximate the curve?

And then, as I already alluded to, sometimes, on a currency swap, for example, that probably appears in your back office in three different areas: one as a U.S. dollar interest rate swap; one as, let's call it, the Deutsche mark interest rate swap; and then in the Deutsche mark/U.S. dollar exchange. So basically, I hope I have made the point that there are a lot of reasons why various numbers could disagree.

As I look at the case from my very naive position as somebody who is about to finish law school, I think that the really key points were: First, SEITA was judged to be a sophisticated institutional investor. That is definitely in the appellate court opinion. And also, the record did not support that they could not find independent valuation. At the time, there were many, many dealers quoting that type of product, so they were not limited to just asking Salomon Brothers.

So I am going to be looking very much forward to hearing what Judge Ramos has to say on this.

I am going to turn it over to you, Martin.

MR. BIENENSTOCK: Our next speaker is going to be Aaron Rubenstein from Kaye Scholer.

MR. RUBINSTEIN: I will try to be brief and not go over ground that has already been covered. Denis Forster covered much of the waterfront of the different types of issues and defenses that are used in derivatives litigation. I would like to focus on a couple that are not that typical and that do not exist in every case.

Every case is going to involve issues of suitability, at least they usually do; they are going to involve issues of what duty exists, how you create a duty, and whether it is fiduciary duty or otherwise. Denis covered the cases that really have delved into that, like *Procter & Gamble*,[3] *Gibson Greetings*,[4] and other cases.

This morning's lecture was very interesting because the industry representatives and the regulators tended to use buzzwords, like most of the transactions in this multi-trillion dollar industry are for "hedging" purposes, the transactions involve a "principal," or "counter-party," (the word you heard most often), and these transactions are usually "transparent" in price.

Of course, that is all true. It is all true because in most of the transactions that is the case, and in most of the transactions, as Denis told you, no problem arises and nothing happens. But derivatives transactions can be used for trading other than for hedging, and that is where the problems arise. They can be used for speculative purposes, with or without the overall company's knowledge and authority.

While the "push the duty away" buzzwords are usually invoked with "counterparty" and "principal-to-principal," sometimes the transaction does not arise that way. As Denis described to you, often what is happening is that lucrative derivatives transactions for dealers arise because brokers go out there, or dealers go out there, and they get clients but do not say, "I am your counter-party, don't rely on me." Instead they say

3. Proctor & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996).

4. In re BT Securities Corp., Securities Act Release No. 33-7124, Exchange Act Release No. 34-35136 (Dec. 22, 1994) (concerning a "Treasury-Linked Swap" between Gibson Greetings and BT Securities Corporation).

"Trust me." They market themselves with "put yourselves in my hands, you can trust us, we are smarter than anybody else in this industry, we can make a profit for you." When that happens, duties can in fact arise, and the courts have recognized that.

And, of course, the pricing can be anything but transparent. Stated otherwise, the transaction can be anything but easy to understand. Sure, most of the transactions can be "plain vanilla" interest rate swaps or "plain vanilla" transactions, but you heard about LIBOR-squared formulas. You may or may not be familiar with things like "guru options," which go on with three-page formulas using almost every letter in the Greek alphabet. The task of trying to price some of these transactions is a daunting one because it involves financial institutions having the most complex computer formulas for pricing them. And sometimes, not always—not even often—but sometimes, it is virtually impossible for the end-users to know whether or not they are getting a fair price or a fair deal unless they just rely on the dealer.

In fact, if I can just touch upon the duty aspect and the suitability aspect, there is no one rule that applies. There is no rule that there is no fiduciary duty ever. In fact, *Gibson Greetings* and *Procter & Gamble* may be a good example of this. That is, there is, in my view, a spectrum out there.

On the one end, I think you may have *Procter & Gamble.* At the time, I think it had $27 billion in sales—I am happy to hear it is up to $31 billion—but it had $27 billion in sales, and perhaps a net worth of $30 billion, and at the end of the day it came into court and said, "We really didn't understand these transactions." It had a financial organization and the financial wherewithal that could have been equal to Bankers Trust at the time. It is one thing in that context for Judge Feikens, to say, "We are not going to shift the onus of a fiduciary duty theory onto the bank to protect you. You could understand it as well as anybody else."

Gibson Greetings was a very different situation. In that case, there were LIBOR-squared transactions put into place that actually put a risk on these transactions for *Gibson Greetings* more than its net worth. That is a different kind of company, a company that was worth $60 million, I think, at the time. That is a very different situation.

In the extreme, you could say there are the *Procter &*

Gamble's on one end, and there are the widows and orphans on the other end. I dare say that no judge is going to deny the widows and orphans some protection against a Bankers Trust or some other dealer, and there are going to be very few instances where a *Procter & Gamble* is going to walk in pleading ignorance and lack of knowledge. Where a particular case falls on the spectrum is really going to determine whether there is a duty or not.

What I would like to talk about now is authority, which is a very important issue. It doesn't exist in every case, because most of the time—at least domestically—cases come up where a Procter & Gamble or a Gibson Greetings does the transaction, and the issues focus on duties and knowledge and suitability. But there are situations where dealers go to companies, or they go to individuals within companies, and they get that individual to trade. Or—dealers are not always evil—individuals within a company who are authorized perhaps to deal with certain kinds of trading, think that they can make the big kill either for the company or for themselves, and they start trading in a different kind of a product, a product that might not be the same kind of hedging product that they have been trading up until then, and they lose a lot of money. Then, when it comes time to pay and the company is asked to pay the dealer, sometimes it says, "I really didn't know anything about those transactions; I didn't know that this employee was engaged in those transactions." These cases present some very messy issues as to whether or not the trades are going to be the responsibility of the company or whether or not there was some duty, some obligation, by the dealer to do enough to find out that the individual was in fact authorized.

The fact is that the name of the game is apparent authority in most of these cases, although there are other authority concepts. Apparent authority requires actions and manifestations by the principal: the company itself that vests the individual with apparent authority. Often, you find dealers relying on what the individual himself or herself told the dealer, such as the fact that the individual provided stationary and letters that he or she created saying that they could do these kinds of transactions. That is usually not going to be good enough.

There are a couple of notable cases, and they do not necessarily arise in the context of derivatives. There are very few decided cases yet on derivatives, so you have to borrow concepts from other areas and try to apply them in the derivatives disputes that arise.

A recent notable case of the issue of authority or apparent authority is a case called *Anglo Iberia Underwriting Management v. P.T. Jamsestech*,[5] a Southern District of New York case in 1999. I don't want to go into the details in any great length, but an employee of a particular company, who had entered into reinsurance arrangements with the plaintiffs, was trying to get money from that employee's own company. In fact, neither that employee nor the company itself was authorized to engage in reinsurance business. The plaintiffs claimed that the agent's use of a company's stationery and the defendant company's failure to disavow the agent's activity created the appearance of authority.

The defendants moved to dismiss. This was an unusual case, because almost all questions of authority, particularly apparent authority, are questions of fact and usually are not decided on summary judgment, let alone a motion to dismiss. In this case, though, the defendants moved to dismiss, claiming that the agent was not authorized, and that any reliance by the plaintiff was unreasonable. The court granted the motion to dismiss.

A couple of things in the ruling are important for the derivatives industry. First, the court said that the plaintiff had asked for proof of authority, didn't get it, but did the transaction anyway. You would be surprised as to how often that happens in the telephone world and document-things-later world of derivatives. That was a critical pitfall. Also, the court said that the novelty of the transaction for this particular defendant should have alerted the plaintiff to a danger of fraud. The ease with which a dealer can confirm authority, particularly when you are dealing with novel, risky, and new transactions like some derivatives, really puts a great burden on the dealer to actually do that.

There is a key quote that I think says it all in this case. It says: "It is beyond peradventure that a simple inquiry into a high-ranking official or executive of [the company involved there] would have revealed that [the employee] lacked the authority to engage in the reinsurance business. However, the plaintiffs made

5. 1999 WL76909 (S.D.N.Y. Feb 16, 1999).

no contact with any of [the company's] officials and executives."[6] That really says it all in terms of the authority issue in that particular case. So I want to alert everyone here, end-users and dealers, that it is going to be a factual issue and authority is not something that can be taken for granted, particularly when you are dealing with foreign entities where the issues of authority may be different than they are domestically.

I now want to talk about one of the items that Denis left off his list, although it may relate to the gaming type of defense he mentioned. It is the issue of the illegality or legality defense. It comes up, not in the *Procter & Gamble* kind of case or the *Gibson Greetings* case, but mostly in foreign cases. We have all heard, and we all know, that the derivatives industry is a global industry. It is an international industry. The world is a vast market for dealers. There are countries—whether they are in Southeast Asia or China or other parts of the world—that are just being tapped by dealers and companies, and that are considered to be prime prospects for the derivatives industry. That is something that raises some unique issues with respect to derivatives cases.

New York choice of law issues, for example, or a New York choice of law clause, which, as we heard, is very common in ISDA Agreements or otherwise in derivatives contracts, may not end any kind of issue with respect to an illegality defense in a derivatives contract. The New York choice of law clause does not, in fact, necessarily govern when the actual conduct engaged in is illegal under the laws of the foreign country where the particular end-user is located.

There are particular concepts that you have to be aware of. The *Restatement (Second) of Conflicts of Laws* draws a distinction that is very important in these kinds of disputes between the existence of illegality in a contract formation or its performance and the effect of illegality on the rights of the parties. While the law governing the effect of illegality is usually determined according to traditional conflict of law concepts—in particular, great weight is given to a choice of law provision in the contract—the existence of illegality is not. So whether or not something is illegal is not based on, or should not be based on, for example, the

6. *Id.* (citations ommitted).

law of the State of New York.

Under a *Restatement of Conflicts* analysis, in this case Section 202, [7] which New York follows, the existence of illegality is determined by the law of the place where the acts related to the contract are performed, irrespective of the presence of a choice of law clause.

What does that mean? That means that if a bank or a dealer enters into a derivatives transaction with a foreign company or a foreign national, and it is taking action in that particular foreign jurisdiction, the bank has to 1) be aware of what the foreign law is, 2) make sure it complies with it, and 3) make sure its customer is complies with it. If the transaction violates the law of that jurisdiction, it may be unenforceable.

Now, there have been cases in the past where the courts, and I believe rightfully, said, "No, New York is so vital as the center of the financial world, let alone the U.S. financial community, that there has to be some certainty in transactions, and so if a New York financial institution is engaging in something like a derivatives transaction or a loan transaction with a foreigner, and they choose New York law, New York law has to govern." But those cases arose where a foreigner—there were a couple of notable cases, one involving an Israeli citizen, the other involving a Greek citizen—where the foreign citizen walks into a bank in New York, enters into a transaction in New York to guarantee transactions for his company, and when there are losses and they try to collect from this individual, that individual says, "You know, the law where I live says this was illegal." The court in those cases has said, "Well, you are stuck with New York law."

It is different, though, where a particular financial institution says, "The world out there is our oyster and we can go and we can do a tremendous amount of derivatives business in Indonesia, Malaysia, Brazil, Argentina, China, African countries, or wherever." Then they go there and they set up meetings, get their contacts, and put their arms around the people in Brazil, Argentina or China and they say, "Trust us, you could make money if you engage in these transactions." If those transactions are illegal there, it is not unreasonable to hold the bank to the law of that

7. Restatement (Second) of Conflict of Laws § 202 (1969).

jurisdiction in terms of the legality of the transaction. That is where the bank chose to go and that is where the bank chose to do its business. It should find out whether or not what it is doing or what its customer is doing is proper. There are a host of cases that address that point.

Finally, on the legality point, I would like to bring your attention to the fact that there may be treaties that are implicated and that may be used by end-users in connection with this legality point. One particular treaty that I would bring to your attention is the International Monetary Fund (IMF) Agreement.[8] Article 8 of that treaty provides that "exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any Member."[9]

What does that mean? That means that if there are foreign exchange agreements entered into with a foreign customer, and under the law of the country where that foreign customer is, those exchange agreements are illegal or they violate the exchange control laws of that country, it actually is a matter of treaty, which is the supreme law of the land, that those transactions cannot be enforced in the United States because the United States is a signatory to the IMF Treaty. That poses, and will pose, a lot of interesting questions, particularly as derivatives transactions spread out into the rest of the world. You are not just dealing with Deutsche mark transactions with German companies or French companies or English companies, all of which have uncontrolled currencies, but you are dealing with foreign countries, developing countries, where there are exchange control laws that have to be taken into account.

In ending, I will say that the fact is that the dealers do not need legislative or regulatory changes. What they need is compliance and enforcement. They know the pitfalls. The fact is that every dealer I know of has very specific policy and procedure manuals that really take all of its brokers and its dealers through step-by-

8. Articles of Agreement of the International Monetary Fund, 1945, 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39 (1947) (as amended).

9. *Id.* art. VIII.

step what they have to get with respect to proof of authorization, for example. Every dealer I know of has a policy and procedure manual that provides that if you are doing business in a foreign country you are required to find out what the legal requirements are and what the legal environment is in the foreign country. The issues for dealers are that they would not have problems if all those rules are complied with. The problems arise in the one percent of cases in which the employees of the dealers—sometimes with the dealer's knowledge, sometimes without the dealer's knowledge—ignore those policies and procedures, and where the institution itself does not do anything, or certainly does not do enough, to make sure that those policies and procedures are complied with.

MR. BIENENSTOCK: Thank you. David Brower is next.

MR. BROWER: Thank you. I am going to speak today about the little guy. While I agree with my colleague that there is a difference between widows and orphans—who, by the way, are rarely trading in derivative products—and *Gibson Greeting Cards*, which I think is a $6 billion company. The difference is that large individual investors or representatives of family funds are being put into derivatives.

Over the years, we have seen a paradigm of how this occurs. It occurs both with American large investors—and I call them large investors because they ultimately wind up putting in a lot of money and the portfolios at some point become worth even more money, and ultimately they lose a lot of money, and they lose the kind of numbers that we are talking about in terms of Bankers Trust. People can lose $10–20 million and, while they are able to sustain that loss, that does not necessarily mean they were too sophisticated to be defrauded. That is simply not the law. I do not know if Bill Gates knows about derivative transactions, and he may have no idea what the swap-squared things are, and he can be as easily defrauded by a broker on the phone as one of the widows or orphans.

What we see is the following. The relationship between the dealer and the large investor, both in America and abroad—normally, we see the foreign investors are Middle Eastern, Asian, or South American investors—is a traditional banking arrangement. These are usually funds that are kept in the United States, for various reasons, due to the laws requiring them not to take money out of their own country. So money earned in this country they try to keep here.

Over a period of time, a broker will call them, or their bank representative will come and knock on their door, make a visit to Brazil or to Tel Aviv, wherever they live, and they say, "You know, we also do brokerage work now. Why don't you buy some stocks from us? We can do a little better on the commissions." They will go with them. They will then start having a portfolio of the usual—of IBM and General Motors, and maybe today eBay. That relationship may go on for months or years.

And then one day, they will get another knock on the door from that same banker asking them out to lunch, and they will be introduced to Mr. Jones. Mr. Jones will be from the New York office of the bank, and Mr. Jones deals in emerging market securities, and they can now do better for them in terms of return than they are doing on their IBM or their General Motors stock. They are then persuaded that Mr. Jones is an expert in this area. They are told how much money the bank has made for people in the past. At this point not a single piece of paper has ever passed between the client and the bank.

From emerging market debt the derivatives start flowing. The client is told: "Well, you can sell some puts and get a premium on those bonds. You can sell some calls and get some premiums on those bonds."

In the course of these transactions, it is explained to them, "You know, you need to open up a margin account in London through either our subsidiary or our affiliate." That is usually where the dealers cross the line, and it happens all the time. The reason they go to London is because they can get 90 percent margin in London and avoid American margin requirements.

As a result, they open it up, they tend not to read the agreements or do not understand the agreements, because they are not presented to them in their own languages. As a result is the client goes on to 80 or 90 percent margin on emerging market debt where they have sold puts and calls or have open short positions with puts and calls covering them. Then, lo and behold, there is a cycle change, the market falls apart, the client receives a call at 2:00 o'clock in the morning their time and is told that they have to put up or do something. They are given about one minute on the phone, and the accounts are closed.

The people wake up the next day in shambles, owing sometimes nothing, or owing a few million dollars, because the banks when they are dealing with individual investors do not extend themselves out so that they have open positions to their own clients for $10 or $20 million. But during this period of time, the IBM stock and the General Motors stock and all those securities have also been sold out to cover the open positions of the option transactions which were derivatives off of the emerging market debt.

These are typical situations. We have seen this situation almost identically perhaps, as I said earlier, once every year in the last fifteen years. The only thing that changes is the part of the world that the person who has made the investments—that is, the client—comes from, because that depends on the economies in the countries they are in and the desire to have cash in the United States and to make investments in the United States.

You then look at the client and you look at the paperwork. The paperwork is always terrible for the client. They have signed five or six arbitration clauses. On a number of occasions, we have seen the arbitration clauses are inconsistent—one will call for arbitration in London, one will call for arbitration in New York. You will see they have signed clauses that say they cannot get punitive damages in litigation. They have signed clauses waiving the right to trial by jury. They understand none of these things because the documentation was never explained to them. The documentation comes from the bank.

Unlike Bankers Trust or Microsoft, these kind of investors do not get to negotiate the terms of the underlying agreements between themselves and the dealers. These are contracts of adhesion. No different than if one of us—or I assume most of us—goes to Merrill Lynch and wants to open up a regular brokerage account. They are going to hand us their brokerage contract; and, if we start negotiating, they will tell you to go down the street to Bear Stearns. They are not going to negotiate with us. The same is true of large, non-institutional, wealthy individual customers. They are not really in a position to negotiate with the banks to change the terms of those agreements. Institutional investors may be.

When we bring these cases, we bring them based on suitability.

The basic suitability argument is that no one understands these transactions, that even the people selling these transactions do not quite understand them. They never explain the risks associated with these transactions, and they cannot explain the risks associated with the transactions. They are financial products that are created and then handed over to brokers who themselves, you learn, do not understand the risks associated with them in many respects.

For instance, many of the brokers or dealers selling those derivatives sold off of emerging market debt, such as Asian or South American debt, in the last five or six years, are not really economists or experts in the emerging markets. Rather they are the people creating the products and do not understand what the risks associated with the underlying debt products, the underlying countries involved, and how quickly those products can go from being worth $100 face to being worth $10 or $12 face. It has happened overnight with respect to South American debt, twice in the last decade.

We have found that there is little reported case law on these cases because they settle very early. They settle when you have situations that fit this paradigm, because the brokers do not explain the risks to people. The tapes that do exist demonstrate that the people are sold a bill of goods, in essence—not necessarily misrepresentations made, solid misrepresentations that you would expect to see under a Section 10(b) claim under the Securities Exchange Act, but representations that "you will make more money this way," "this is the way you should do it," or "we know what we are doing, follow us."

And then, when the book is closed on the situation, you really hear it because there is usually panic in the voice of the dealer—or in most cases at that point, the secretary for the dealer, because the dealer does not want to get on the phone with the customer and start explaining what has happened. They are told by a secretary or an assistant, "You have to give us $5 million or we are going to shut the accounts." The dealers do not even explain at that point what "shut the accounts" means, because shut the accounts means "we are also going to liquidate all of your equities we are holding on the other side of the bank; and, by the way, if you have any cash in the bank, we are going to grab that too." Generally when dealers do that, given the way it is done and the circumstances under which it is done, you can normally make out a case for unsuitability.

In order to explain the risks, you would need to give someone a disclosure statement with respect to these products that was 600 pages long. Now, obviously, you cannot do that with respect to every individual investor, which leads to the question maybe these are not products that dealers should be selling to non-institutional clients that do not have their own analyst departments. The law may develop that way, that unless those are the kind of clients they sell to, or they have some demonstration that the client is as capable as the person creating the product of understanding the product, the dealers are going to be essentially absolutely liable for the losses.

I did want to add one more thing. We have spoken today about lots of causes of action. I think Denis Forster touched on this point, but I think it is important. Unfair and deceptive trade practices has not been a cause of action generally used, certainly not in New York or elsewhere, with respect to securities transactions. It is a developing area of the law in New York and up until very recently was not a very profitable area of the law for a plaintiff to pursue.

The New York Court of Appeals has recently, in a series of what are called vanishing premium insurance cases, very broadly interpreted New York's unfair and deceptive trade practice statute much more in line with what the majority of states now interpret unfair and deceptive trade practice statutes to be. This may be a very important line of attack by plaintiffs and a very difficult defense by dealers in the future, for a number of reasons.

Unlike under Section 10(b) of the Securities Act, even in an unsuitability claim, you have to show justifiable reliance; you have to show scienter—that is, conscious intent—on the part of the dealer to defraud or to breach its other duties.

Unfair and deceptive trade practice claims do not require that the individual plaintiff actually be deceived. They do not require reliance. They are strict liability statutes. They do not require bad intent or scienter on the part of the defendant. They simply require an injury and causation.

Under those statutes, I believe we have seen over the years, a paradigm of this kind of contact: the dealers go out and solicit or recruit certain kinds of investors at certain times in certain parts of the world, invest them in the same sorts of products, and then close them out without giving complete information or complete risk disclosures. In this type of situation not only are companies going to be facing individual claims under these unfair and deceptive trade practice statutes, but they are going to be seeing, for the first time, class action cases brought under these statutes. Unlike the difficult individual issues that may make these types of claims unsuitable for class treatment, unfair and deceptive trade practice claims are not only suitable for class treatment, but generally they are written in a way that makes them class by definition.

In California, for instance, the unfair and deceptive trade practice claim is class by definition, and if you win, you have won for the entire class of people that the practice was conducted upon, whether you brought it as a class action or not. So that is an issue that is going to be rising in the future, particularly given how much of the business in derivatives and the products that derivatives are sold off is done in New York, both with American clients as well as foreign clients.

Thank you.

MR. BIENENSTOCK: Thanks. My job is to give you a flavor of things that have not been said that only arise in bankruptcy cases. Let me try to tell you a few stories where the gist or the drift will get across.

Chapter 11, as you know—you read about it in the newspaper, your friend Judge Mayo pushed Texaco into it—is based on a set of public policies that put reorganization of a company to preserve jobs, and to promote Gross Domestic Product, employment, American enterprise, ingenuity well ahead of getting creditors paid quickly. That is our national policy.

The other policy in Chapter 11 is that those people who end up taking the hurt have to share it equally. So there is the equality policy.

Now along comes a Chapter 11 or a Chapter 7 debtor that owes a financial institution or broker or broker-dealer on a derivative contract. The policies I just mentioned were determined by Congress to be subordinate to another set of policies, really just one policy. That is that the stability of the capital markets is supreme. And no matter what you have to do to close down a business—fire everyone, make people share losses unequally—that is all okay if you do it in the name of preserving the stability of the capital markets. The fear is, obviously, that if one financial institution cannot collect on an interest rate swap, or whatever the derivative is, then that institution may default to another financial institution, which will default to the next, and the domino effect will bring down the wealth effect in a hurry.

So to carry out the stability of the capital market policy, Congress inserted into the Bankruptcy Code in 1978, and has since then spruced it up somewhat, a set of provisions designed to insulate derivative contracts from the operation of the bankruptcy laws. If they had done a complete job, then I could sit down.

The problem is that there are these little holes that people on the panel tend to find and it becomes quite tricky. It also becomes an area where ingenious lawyers can create some novel commercial transactions, which I just want to give you a flavor of.

First, the normal bankruptcy statute in Chapter 11 automatically stays the action of a creditor to collect a debt. So ordinarily, if you are a broker and a customer goes into Chapter 7, Chapter 11 or Chapter 13, and you have any type of derivative contract with that customer, you cannot do anything about realizing on the collateral security or the margin account that you have, because the automatic stay applies.

The essence of all of the Bankruptcy Code provisions that were inserted to insulate derivatives from the Bankruptcy Code, is that the automatic stay does not apply. Congress and several New York law firms were fairly clever and realized that just because the automatic stay does not apply, that does not mean the bankruptcy judge will not issue a new injunction. They used belt and suspenders, and there are provisions, such as Bankruptcy Code Section 555, which says no United States court shall issue any order designed to enjoin the enforcement remedies of certain entities on their derivative contracts when the counter-party is in bankruptcy.[10]

Now again, if they had done that completely, I could sit down. But they did not. The only people who can benefit from the

10. 11 U.S.C. § 555 (1994).

insulation of the derivative contracts are enumerated in the Bankruptcy Code, and it is a broad category: financial institutions, broker-dealers, clearing agencies, forward contract merchants, and the like.

So the first problem is to make sure that if you are doing this and you want to protect yourself against counter-party bankruptcy, that you do it in an entity that is specially protected under the Bankruptcy Code. It is not hard. You just have to focus on it and make sure you use that entity. They are not hard to create if you don't already have one.

Parenthetically, you may note, this is not a particularly profitable area of the practice. So let me warn you, even if you are interested in this, you may want to think twice. Many issues arise and are resolved in seconds.

When the High Risk Opportunity Fund (HRO) was in trouble and it ended up in bankruptcy offshore, I got a call—and I wasn't alone—from some money center banks. Usually the call stems from the inside general counsel, and in short order the trader is on the phone. The trader's attention span you are familiar with better than me, and the decibel level of the voice—"Well, I got this firm for two minutes, so what do I do? Do I glom onto the $50 million offer of margin or what do I do?" If you give the right answer and you save them $50 million, if you don't bill per second what you normally bill per hour, it is not a lucrative practice. But that is how these situations arise.

Now, once the bankruptcy starts, I told you that if you have done it in the right entity—a financial institution, a bank—you are insulated from the automatic stay. But Congress sort of left a loophole there too. The automatic stay and the insulation from the automatic stay apply to Chapter 7 debtors, Chapter 11 debtors, and Chapter 13 debtors. They forgot about Chapter 9 debtors, municipalities.

So when Orange County went into Chapter 9 under the Bankruptcy Code, all of the big investment banks in New York were ready to grab their collateral security, and many did. But they did not realize that Section 555, which lets you override the normal unenforceability of a bankruptcy clause, was not made applicable to Chapter 9. I cannot tell you how many large investment banks in New York wrote big checks to Orange County because they thought the automatic stay did not apply to them. They thought that they could use Section 555 in Chapter 9, and it just wasn't that easy, to put it kindly.

Now, another thing the Bankruptcy Code does is that it protects the privileged class—the financial institutions, broker-dealers, et cetera—from avoidance actions, except for actions based on actual intent to hinder, delay, and defraud creditors. What does that mean? If you have a naked or an under-secured account with a counter-party, and you are worried that it is going to go into bankruptcy and you grab collateral at the last minute, within ninety days of bankruptcy, ordinarily that is set aside as a avoidable preference. Not if you are a privileged class and not if it is a derivative contract. So is that good? Well, yes, that is terrific, but that gives rise to all sorts of wonderful abuses.

The legislation goes so far to insulate derivative transactions from the avoidance powers. It says, "settlement payments handled through a securities clearing agency are exempt from the avoidance powers." Well, when you do a standard leveraged buyout, where a company borrows enough to make it insolvent, then dividends the money out to its shareholders, if it does it through the clearing agency, the circuit courts have said you may not touch it under the avoiding power. It is not a fraudulent transfer unless done with actual intent to hinder, delay or defraud.

So what happens? People come to you all the time: "How do I structure this so it will be invulnerable from attack in bankruptcy as a fraudulent transfer?"

Now, the automatic stay is what secured lenders hate when it comes to the single-asset real estate cases. They have a mortgage on a building; on the eve of the foreclosure sale, the owner puts it in bankruptcy; you cannot foreclose. Why put up with the automatic stay if you can restructure the secured loan as a series of derivatives contracts which are exempt from the automatic stay?

Now, are the bankruptcy courts going to go for this and let you foreclose? The literal application of the law—there is something to be said for that—should render the foreclosure exempt from the stay. Bankruptcy types, like myself, say that that is really against the spirit and the policies and is not going to carry much weight in the district and appellate courts.

Finally, let me mention a novel theory attempted in the

Orange County Chapter 9 case. Orange County is probably one of the only entities to ever read the Constitution of the State of California. And, lo and behold, there was a provision in the Constitution that says a county is unauthorized to incur debt beyond its annual revenues. Well, it lost so much money on its derivative contracts, they said, "You have to give it all back. We were unauthorized to enter into those contracts." That was settled. All I can say to you is that you ought to read your state's constitution. You might find something you never expected to see there.

Those are actually all my comments. Thank you very much.

DERIVATIVE SALES TO FUNDS AND RESULTING LITIGATION

MS. JACKSON: Let's go ahead and get started. I am going to introduce you to the moderator of the next panel. They are going to be looking at derivative sales to funds and the issues that arise, and they will probably even go beyond that.

I would just like to say a few words about David Morris. He is a Partner at Fried Frank, where he is active as counsel to broker-dealers, hedge funds, and investors on deals and structures involving a variety of derivatives, repos, CMOs, and other types of derivatives, including swaps. David, I turn it over to you.

DAVID MORRIS:* Thanks. There are three topics that we are going to talk about. One is the allocation of responsibility between brokers, fund managers, investors, and the funds themselves. Another topic is the significance of fund investments in illiquid securities and, in particular, illiquid collateral. There was a lot of talk this morning about the increasing importance of collateral, and we thought we would focus on illiquid collateral, in particular. And then finally, some of the effects that leverage is going to have.

The paradigm case that we think about is a fund that invests in some kind of derivatives, things go swimmingly for awhile, and then things don't go swimmingly anymore, someone loses a lot of money, and then there is a lawsuit.

Three of us were involved in a case, called the *Askin*[1] case, which is still ongoing. I was involved in that case representing Bear Stearns, and Peter Morgenstern and Eric Seiler represented other parties. Let me ask them to introduce themselves and say one or two sentences about that case.

PETER D. MORGENSTERN:** The *Askin* case which David refers to actually consists of two dated, but separate actions. Eric really primarily focuses on one side of the case, as attorney for the legal successor to the Askin-managed funds themselves that

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* Partner, Fried Frank Harris Shriver & Jacobson.

1. Granite Partners, L.P. v. Bear, Stearns & Co., 58 F.Supp.2d 228 (S.D.N.Y. 1999); Primavera Familienstiftung v. Askin, 113 F.R.D. 115 (S.D.N.Y. 1997); ABF Capital Mgmt. v. Askin Capital Mgmt., 957 F. Supp. 1308 (S.D.N.Y. 1997); Primavera Familienstiftung v. Askin, 1996 WL 494904 (S.D.N.Y. 1996).

**Partner, Bragar Wexler Eagel & Morgenstern, LLP.

ultimately went into Chapter 11. The Chapter 11 plan created an entity called the Litigation Advisory Board, which was empowered to file claims on behalf of the bankrupt funds themselves which Eric will discuss.

I represent a large group of investors who, together with other groups of investors brought separate claims which have been, over the four years or so of the litigation, whittled down to basically fraud-based claims against not the funds themselves, because the funds were in bankruptcy, but against the manager of the funds, the investment advisor to the funds, and also against the broker-dealers who sold to the funds and who we allege aided and abetted David Askin's fraud on his investors.

The investors collectively suffered losses of approximately $500 million in the three funds that were run by David Askin, which were purportedly market-neutral CMO funds. The continuing litigation that we are involved in now, involves fraud claims against Askin as well as aiding and abetting claims against certain broker-dealers for selling Askin unsuitable securities and enabling Askin through the mark-to-market process to mislead his investors about the value of the funds.

ERIC SEILER:*** It is interesting to hear David refer to it as the "Askin case." It illustrates the point I am about to make. We do not refer to it at the "Askin case" because we represent the funds, and one of the big issues is are the funds charged with the conduct of Askin. So we call it the "Granite case" because Granite was the name of the Fund.

We really stand in the shoes of the trustee, the funds having come out of bankruptcy—or liquidated, actually—with the only residual asset being the claims against the broker-dealers. We bring those claims standing in the shoes of the funds. So the issues of suitability, which have been discussed most of the day today and which we tried to make our issues, ultimately, at least at this stage, are not our issues because, whether we were defrauded into buying these securities or whether there was a fiduciary duty breach by the fund manager, the court has held that we are, for those purposes, the same as the fund manager, and so, *in pari delicto*, we cannot bring those claims.

***Partner, Friedman Kaplan & Seiler.

You would think, having heard everything so far today, that there is not much left for the funds to do. But, as David pointed out, the case is continuing as against some broker-dealers and it is settled against others, including David's client; because the other attribute of what happened here is that the funds went into bankruptcy and they were liquidated. So an entire set of issues are unique to this kind of fund litigation, relating to when can you liquidate, what can you do when you liquidate, what do you have left after you liquidate, and whose is it.

I am going to talk more about that as we go through the topics, but those claims, which very much turn on the valuation of securities, are alive. These claims have been settled for a lot of money where they have been settled, and are currently being pursued very aggressively. And, unlike what everyone else has talked about, I think this case does get tried, both for the funds and for the investors. It has been through virtually every kind of motion practice you can imagine. The fund meltdown took place before the Procter & Gamble and Gibson Greeting Card events, which were in late 1994. This all took place in March of 1994. Fact discovery concluded at Christmas and expert discovery is ongoing. The trial is going to be in the spring, or the fall more likely, so it is an active case.

One little footnote. There is a confidentiality agreement in place, so there are things that we cannot talk about; and there are adversary counsel who are present, so there are things we will not talk about.

MR. MORRIS: There are spies, I think, behind every pillar. Let me ask Michael Malone to introduce himself and talk about what brought him here.

MICHAEL J. MALONE:**** I am not involved in the Granite litigation, but I did want to briefly mention that I heard David Brower on the last panel say that you don't see widows and orphans investing in derivatives. Well, I am here to tell you that America is a wonderful country, and in fact, in the early 1990s, there were a great many litigations in the Southern District and in the Second Circuit, and in some other circuits as well, that involve funds similar to the Granite Funds—that include the Piper Jaffray

****Partner, Battle & Fowler LLP.

funds, *Blatt v. Merrill Lynch*[2] in New Jersey, the Alliance Income litigation, and the TCW/DW Term Trust litigations. All of those funds were created by money managers who are expert at juggling derivatives, at least as much as anybody is expert at juggling derivatives.

In the early and mid 1990s, what you had in the markets was a very substantial fall and then substantial increases in interest rates. The fund managers who were juggling those derivatives found that they did not always react in a way that was very beneficial to the financial fortunes of those funds.

It created a lot of good old-fashioned securities class action litigation. It didn't have the same elements as the litigations that we heard about from the first panel. They were your basic bread-and-butter claims that the prospectuses did not adequately disclose the level of risks in these derivative instruments, the types of hedging that were going to be used, the types of leveraging that were going to be used, and the efficacy of those techniques.

I represented the Hyperion Funds in litigations of that kind. The Hyperion Funds were affiliated with Louis Ranieri, who is the highly recognized father of the mortgage-backed securities market. In the view of some, Mr. Ranieri created that market back in the early 1980s.

What those funds did was they took mortgage-backed instruments that had a volatility when they were alone and they put them into a cocktail that was, hopefully, going to neutralize the volatile potential of each of the funds. Those funds were, in turn, sold to the public, about $1.2 billion worth. In the very strange interest rate environment that occurred in the early 1990s, they dropped in value over $300 million. Without going on at any great length, I would just say in situations like that, "plain vanilla" litigators like me come in, and we look at the prospectuses, and we try to litigate these derivatives cases like any other securities class action litigation. That is, we focus on whether the disclosure was adequate.

The suitability issues that have been mentioned also come up in that context because, as you know, under the Reform Act[3]

2. 916 F. Supp. 1343 (D.N.J. 1996).
3. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737

especially, you can, through motions to dismiss, put off the discovery phase in litigations of this kind for several years. And hopefully, as in our cases, you win on a motion to dismiss and the case is over.

But during that two or three year period, while you are battling to try to get the complaint thrown out on a motion to dismiss, there are some resourceful plaintiffs who have enough money at stake that they take the suitability route and go after the brokers who sold them the funds containing the frizzy cocktail. That is a very interesting tactical issue, because I don't think any defendant who is dealing with one of these things in the Second Circuit, or before a Federal District Judge, at a motion-to-dismiss level wants a suitability case going through an arbitration, through full discovery, and through the testimony of everybody involved.

I think that maybe one of the reasons that one of the gentlemen who was speaking before said that most of these suitability cases do not go the full distance is because the defendants are likely to have a lot of other irons in the fire in these cases. So to settle a single suitability claim is often a very wise decision tactically.

MR. MORRIS: This morning derivatives were explained as being mostly bilateral. One of the things about funds that buy derivatives is that they are no longer bilateral; there are a number of players—the investors in the funds, the funds themselves, the fund managers, the dealers who sell the derivatives to the funds, and the people who introduce the investors to the funds. So there is a five-level series of players.

Let me now ask the panel to talk a little bit about the relationship between your theory of what went wrong, or your legal theory, and which of those various five players you can look to pick up the bag at the end.

MR. SEILER: Probably the most interesting thing that has come out of the Granite-related litigation on that question is that there is no doubt in anyone's mind that the fund manager owes a fiduciary duty to the fund and its investors. There is probably equally no doubt that you could articulate a theory, if you have the right facts. For instance, the broker-dealer community could

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(1995).

potentially aid and abet a breach of fiduciary duty if, for example, they conspired with the fund manager to try and not follow what the disclosure was to the investors or to sell inappropriate securities to get large commissions. Whether that happens or not is a factual question, but you could think that it is a core claim that investors or the fund should be able to bring against the fund manager or the broker-dealers.

The anomaly, or the interesting result, in the Granite litigation is that the investors cannot bring those claims because they do not have direct claims against the fund manager. They can bring a claim of fraud against the fund manager, but they cannot bring a fiduciary duty claim against the fund manager in their hat as investors because they don't have standing to do so, and certainly they cannot bring the claim for aiding and abetting a breach of fiduciary duty against the brokers.

At the same time, the funds have been precluded from bringing those same claims because they are charged with the conduct of the investment manager, the fund manager, under the *in pari delicto* defense. So you have an anomaly where there is a recognition that there is a fiduciary duty that could be interfered with, but neither the fund nor the investors in the fund can bring that claim. At least that is an anomaly that exists absent further judicial review.

You would have thought going into the case that it would be one of the causes of action that would more likely stick as a matter of pleading, where another cause of action that has survived might have been more attenuated. So this is just one perspective.

MR. MALONE: Eric, I have not read those cases and I have not been involved with them, but I do not understand why the fund is not treated like any beneficiary of a trust, and why the advisor is not treated like a drunken trustee. I mean, why should the trust be precluded by *in pari delicto* from suing the investment advisor who allegedly screwed up in putting instruments into the trust that were not appropriate for the trust?

MR. SEILER: Probably in the context, of course, that the investment advisor has no money, so the real issue is the aiding and abetting of the breach of fiduciary duty on the part of the broker-dealer. But the analysis would be the same. I would say "Why indeed, why not?" because that is the position we asserted. But the rationale is in the reported decision in this case that there is an *in pari delicto* defense because the fund manager was acting on behalf of the fund and he was cheating—and so it's your cheating, Mr. Fund; it's not his cheating, it's your cheating.

MR. MALONE: I think David did some job in winning on that argument. I think we owe him a round of applause.

MR. MORRIS: Well, I think what the judge was saying is that in some sense you should not treat the fund as independent from the fund manager, that the fund and the fund manager have exactly the same interests, the fund makes no independent decisions, and that it does not make sense to say that the fund has an independent existence from the fund manager to be able to turn around and accuse itself of having done something wrong. I think that is the argument.

MR. SEILER: This is not an issue that is free from doubt from jurisdiction to jurisdiction. It comes up, not in this context as often, but in claims against professionals, and accounting malpractice cases, where you have a company that has gone into bankruptcy, and the question is whether or not the people who were running the company for you were doing it for the company or doing it for themselves. And, there is a whole doctrine—which you could count the cases on your two hands, not in hundreds of cases, and it is not free from doubt, but in this case that is one of the things that came out.

MR. MORGENTSTERN: Unfortunately for the investors in the Granite case, the court rejected our argument that the investors should be able to accede those claims that were barred on behalf of the fund's successor by the *in pari delicto* defense. So, as Eric said, the anomaly was that it wound up just knocking out the claim entirely from the case, although many of the facts and circumstances that supported the breach of fiduciary duty claims and the aiding and abetting breach of fiduciary claims survived because they constitute the same sort of core facts and circumstances that underlie the fraud claims that we are still pursuing in the case.

MR. MORRIS: At the risk of trying to elicit some speech-making, let me ask the panel this question: how much responsibility do broker-dealers selling derivatives to funds have to make sure that the derivatives they are selling are consistent with the funds' investment goals and the funds' strategies?

MR. MORGENSTERN: I will start. Well obviously, in our case the brokers take the position, that they are in the business of selling securities, and that is simply what they did with respect to funds. We allege that there was more of a symbiotic relationship in this case between the brokers and the funds which far surpassed the ordinary relationship between a customer and its broker.

In our case, the brokers were financing Askin, they provided certain analytic support for Askin, and were providing Askin with a month-end mark which formed the basis for his monthly net asset value reports to his investors. There are allegations in our case that the broker assited Askin in reforming smoothed out and false results to his investors.

I think you have to look at this sort of case as similar in some respects to a lender liability case. You should look at the involvement of the broker in its customer's business, the level of their knowledge of and support provided to the customer. It is certainly in many ways the degree of their involvement.

QUESTION: At what stage in the litigation did Judge Sweet decide the issue of broker-dealer responsibility?

MR. MORRIS: The motion to dismiss on the complaint, just on the pleadings.

MR. SEILER: This is a case that has the unusual aspect that a tremendous amount of discovery took place before any of the decisions and the motion to dismiss were decided. So you had complaints that, while they were still being treated under the standard of motion to dismiss, had very detailed factual allegations, all of which is under seal because the court allowed the discovery to go ahead, and there were a series of motions to dismiss. It is unusual in that regard, so you might be able to read more into the court's thinking about the facts since the facts are more established.

QUESTIONER: I was just going to say that sometimes you preclude yourself after a motion to dismiss, but then you've got a viable cause of action and you run into summary judgment.

MR. SEILER: Right. I think that is often. I agree with that, but this case is unusual.

MR. MORRIS: I am not sure the defendants would agree with that.

MR. SEILER: I think on this issue that they are likely to make summary judgment motions.

But just to come to this point from another perspective, I think that the broker-dealers, even if they could get out of this part of the claim, the suitability part of the claim, if you go back to what was said this morning, there was undoubtedly in this case a breakdown in, if you want to call it, best practices. Whatever the credit side of the firms had to think about—"should we be selling to this guy, should we be financing it with 95 percent repo financing"—was overridden by the desire of the people making the products—and there were the esoteric tranches of an entire spectrum of securities, and if you didn't sell this piece, you couldn't sell the whole piece. They were making a ton of money on the whole package.

Askin was buying the entirety, or virtually the entirety, of the key tranche, and they needed him. In the dynamics, until it blew up, the credit side was not in charge, the trading side was in charge, or the new product side was in charge.

The sort of bitter lesson of it is even if you can throw out all of the suitability claims, at the end you had a failed customer who was riding an entire market, a market which melted down, even if they never had to pay back another penny. In fact, they have had to pay back another penny because the liquidation treatment at the back end was done in a way that created a specter, at least, of liability that has led to some substantial settlements.

So I think, from their own parochial point of view, the broker-dealers needed to do a better job with this customer because they ended up paying a lot of money not having done that so far. I don't think that is an unfair characterization.

MR. MORRIS: That is a fair characterization of the broker's own internal, I would think, goals and needs. The problem from an industry perspective is that if you make broker-dealers responsible for enforcing the strategy of fund managers, you turn the brokers and the dealers into fund managers. If a fund manager comes and says, "I want to buy this derivative," the dealer then needs to say, "Well, can I see your entire portfolio? What is your thinking?" And then, if they have disagreements, I think the plaintiff's theory would be you should say, "No, I won't sell you these derivatives," and essentially you have reduced the number of investment advisors to be coextensive with the number of dealers.

MR. SEILER: I think that is a very fair point. But if these guys had done their jobs perfectly and the firms had worked internally, there still would have been the issue of, "Well, if you have a good portfolio with me, you're a little long. What if you are really long with everybody else on the street? How do I know that?" We didn't get close to that in this case, but I think that is a fair point.

If you are relying on regulating the brokers to regulate the whole business, the brokers do not see the whole market, even in a very narrow market.

JUDGE RAMOS: Judge Hellerstein and I have come to the conclusion that we could rule on your case and save Judge Sweet some time.

MR. MALONE: The funds were managed by people who had to be expert because when the funds were still viable, before the meltdown, they were turning around to the general public and selling shares in these things.

MR. SEILER: Actually they were sold all to institutional investors. Our investors are all institutions and not the general public.

MR. MALONE: Okay. Nevertheless, they had to be experts in trading the derivatives themselves. So I just find it hard to swallow putting off the proper suitability of the instruments onto the broker-dealer from whom they buy. It is like Leonardo da Vinci going back and saying, "Look, you sold me the wrong paint."

JUDGE HELLERSTEIN: Speaking from the time when I was a lawyer, which was not too long ago, there is another layer of issues that comes into these cases. Because the brokers get business, some of them will often assume responsibilities within the firm, as was said before, of analysis and recommendation. In addition, there are various private agendas that various fund managers have to make appearances look better than maybe the facts allow. The result of all of this is a blurring of the division between who is the seller and who is the buyer.

I think that what was happening in this motion before Judge Sweet-and I haven't talked to him, so I don't know—is an effort to test, by a Rule 12(c) motion, a judgment on the pleadings, whether the allegations take in as much as they can and state a cause of action. Judge Sweet held, apparently, that they do state a cause of action. Sometimes you will take that theory because the facts are so mixed and the case is so expensive, and you cannot hope to win a motion for summary judgment. So you will take a chance of winning, or trying to win a motion of judgment on the pleadings that will assume the facts to be true and challenge the legal sufficiency. It is a long shot, but it may be the best shot.

MR. SEILER: Maybe this is a good place to transition to the whole issue of the illiquid securities.

MR. MORRIS: Sure. Why don't you just take that one and run with it?

MR. SEILER: An issue that permeates our entire case is that the securities were all highly illiquid, so there was no readily ascertainable market. Often, Askin bought a tranche and held it until the fund blew up. So if you don't believe that there are comparable securities, you have a hard time figuring what the securities are worth.

And, as they had to, the brokers marked the securities every month, as they do for lots of other funds. The brokers marked them every month for the fund manager, because the fund manager, in turn, had to report to the investors how the portfolio was doing. There are a number of allegations in this case that the process was corrupted by the fund manager's desire to have a certain result and by the brokers' willingness to cooperate in that process.

That is a set of claims that exists in the case, but it also created issues at the back end of the case, because all along they had been marking them a certain way, and now, suddenly at the end, they get nervous because the market has moved a little. They are nervous about what each other broker is going to do, and there is dramatic marking-down of these securities, leading to margin calls.

If you looked at the slides that were up earlier—the bid side, the ask side, the middle—and then you were over here somewhere below where the bid had been hours ago, and there was no real move in the market. So even if you do not look at the end-of-day price, you just look at the consistent marking that they were using for their own securities, the question is whether there should have been a margin call. But then, taking the last step, you have seized all the collateral because the margin calls are not met, and now you say, "I am going to give you credit based on what I say they are worth." Then you go out and resell them, if you are a broker-dealer, let's say hypothetically, that very afternoon for markedly more money. Then the funds come and say, "Wait a minute, that's my money, not your money." That is the core of the fund's case that is still left, which is what we call the liquidations part of the case, which is a $100 million claim altogether between the different broker-dealers, or a little more, so it is real money that is at issue. None of that would happen if these were securities that had readily ascertainable prices at. You would have a bid-ask spread on them, but you at least could have a number.

QUESTION: Were these all derivatives products or were they actual securities?

MR. SEILER: They are all derivatives—inverse IO floaters. They are 99 percent derivatives off of Ginnie Mae-type securities.

MR. MORRIS: So in some sense they are government securities; they fit in the box of government securities.

MR. SEILER: There was no underlying risk or loss of value of the securities. The securities were paying the coupons every month, and principal and interest, like clockwork. It was all a change in the valuation because of moves in the market.

MR. MORRIS: One of the important things that issues related to collateral should mean to the industry, is when you are relying on collateralized derivatives, your credit is only as good as the valuation process you have on the collateral.

One of the questions to ask is, where are those marks coming from and exactly where are they? I can think of four different meanings for what a mark is. A mark could be 1) what the dealer who is giving it to you is willing to pay for it today in ordinary markets; 2) what he would pay for it today if there were an immediate forced liquidation; 3) what someone else might pay for it today in ordinary markets; and 4) what the dealer predicts someone else might pay for it today in liquidation. Those numbers in an illiquid security could be 25 percent or more apart from one another. That is a huge difference if you are relying on that security as the credit support.

JUDGE RAMOS: There is another variable too between a liquidation in an ordinary market and a liquidation in a panic market.

MR. SEILER: I think it is safe to say that the issues of what duties the broker-dealers have under all those circumstances, both marking for margin purposes and liquidation and how can a liquidation be conducted, is a relatively undefined area of the contract law.

JUDGE HELLERSTEIN: There is an analogy for secured debt that has been working. Namely, that the creditor can take the security—and most agreements will allow this to happen—and, either in a public or a private sale, sell it off and any excess goes back to the debtor. It is a fiduciary obligation of the seller to act in a judicious or a commercially reasonable manner.

The problem is that when you get into a market where there are few buyers and sellers and it is highly volatile, it is difficult to establish value. But there are not many applications in terms of derivatives and in terms of working different kinds of exchanges. The derivatives you are talking about match a highly illiquid part of the deal against a liquid part of the deal, with an over-pledging of one end to sustain a speculation on the other end, very broadly speaking.

So if the market collapses, the broker has the ability to grab the liquid part of it. If he is over-secured, the broker can protect himself as against the rest of the world, and other creditors complain. That was an aspect of the Orange County debacle as well.

If the broker is protecting himself with relatively illiquid securities and the broker is probably the only one making the market, he will take it in a private sale and then the valuation is anybody's guess.

I don't know if there are really different things that you can say about the law that are applicable to this kind of verified transaction as against the common run of transactions. Judges, even those of us who are brilliant, tend to apply what we have learned a long time ago to new situations, until we are shown that it does not really work and someone is getting a really rougher end than he should get and another party is getting a big benefit out of it—especially if the morality of the dealings have been corrupted in some kind of a fashion. Then we try to make rules that fit the situation.

MR. MORRIS: One of the differences, Judge, between the markets, just for example, the financial markets and the real estate market or the other kinds of secured loans is Congress' concern expressed in the bankruptcy context of the ripple effect. To have a sale on the courthouse steps with notice measured in weeks, or even days, I think Wall Street at least would say disrupts the financial markets.

JUDGE HELLERSTEIN: It would. There are a whole range of brokers—and I represented one—who before the Orange County debacle was able to take in their security and come out whole. Others got stuck and could not and had to wait a long, long time. There is a mixed effect on this.

But there is another analogy in the Uniform Commercial Code, where you can have a private sale. Most of the time the Uniform Commercial Code deals with products where there is some ascertainment of value, however rough or difficult, in the area that we are talking about.

MR. MORRIS: There is a question over here?

QUESTION: Any thoughts about the illiquidity that comes from what the dealers recently experienced, which is the GKO market in Russia that just tanked in the fall of 1998, and that created some interesting valuation issues that were, I think, somewhat different than what happened in *Askin*?

MR. SEILER: I think that part of the brokers' position is that there was a dramatic market move even in *Askin*, and so they were fairly valuing the securities. It was just that they had lost a tremendous amount of value. I think that is a better argument when you are talking about the Russian bond market than it was when we were talking about derivatives off of Fannie Mae's or Ginnie Mae's, because there was a preexisting methodology that the firms used. Sometimes it was relative—depending on the particular security, it was either very sophisticated or less sophisticated.

But if you use it every day and then on Tuesday you say, "Well, I am just knocking everything down by 30 percent," that at least raises a question as to whether that is commercially reasonable. Especially if on Tuesday you know you are marking it down because you are going to own it, and you are basically setting the price at what you are buying, that is a somewhat different methodology than you used the day before.

I think the brokers would like to be able to defend this valuation issue by saying that it was just a result of the spreads widening in the Treasury market. I think that is a factual question. If they could prove that, that would be good. If they cannot, that is a problem.

I think with Russia there was clearly a dramatic widening between other debt securities and Russian debt securities, so I think it is a different situation, and I am not aware of any of these issues being raised in any litigation coming out of that.

JUDGE RAMOS: Well, in the Russian situation, for awhile there was no official exchange rate. The Russian banks were not quoting the ruble.

MR. SEILER: I think they would have a harder case if Askin had been investing in the Russian market in 1998. They wouldn't have gotten any money from Bear Stearns.

TOTAL RETURN SWAPS AND SWAP CONTRACT LITIGATION

JOHN D. LOVI:* I should just explain briefly how I came to this position. When I started in practice, right out of law school a number of years ago, I was able to explain to a partner at the law firm the difference between a put and a call. As a result, I was put in the securities litigation department. Today, I represent, on the dealer side, a number of sophisticated hedge funds and dealers who create OTC derivative transactions that, unless you have a supercomputer, you wouldn't even begin to understand.

How I wound up representing end-users—and that is really what I am here to talk about—was odd, in the sense that I was always, as other speakers have mentioned earlier, a bit skeptical of end-user claims. Beginning with the Bankers Trust cases, I have always represented the dealers and the dealers' interests throughout this period.

In early 1998, the most profitable bank in Korea—that was before they ran into a little bit of a derivatives problem—called me and asked if I would represent them because they were the end-user guarantor on a transaction that created well over $300 million in losses, and they thought this was a risk-free trade.

So I flew all the way over to Korea—it is a sixteen-hour flight; I don't wish that upon anybody—and I was expecting to see the most profitable bank in Korea. Just to give perspective about what a sophisticated investor is—the most profitable bank in Korea or the third-largest life insurance company in Korea may sound on its face to be extremely sophisticated. It is not; far from it.

I was introduced to the individuals at the bank involved and they took me through their understanding of the transaction with a grease pen on a bulletin board and, I swear this is a true story—an abacus, that's right—an abacus. They gave me their abacus as a souvenir, and my children now have it. They thought they understood this transaction by flipping those little beads back and forth and diagramming it with a grease pen. And they swore that they understood the transaction cold and could not understand how it is that one day J.P. Morgan writes them a letter that says

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* Partner, McDermott, Will & Emery.

"you owe us $300-some-odd million; by the way, send us a check tomorrow." That was Christmas Eve, 1997. In any event, that really did change my perspective about what can be done for end-users in litigation. That case has now settled.

I am currently representing what used to be the third-largest life insurance company in Korea, now taken over by the Korean government because they had some financial difficulties, in another derivatives transaction.

We have talked about, and you have already heard a number of causes of action that arise out of OTC derivative transactions, and my current lawsuit states a number of those as well—fraud, suitability, breach of fiduciary duty, *ultra vires*, illegality, and numerous variations of those same causes of action.

However, what I want to focus on in particular are two common elements of nearly all large derivative loss cases and demonstrate how the application of common law principles of contract ought to provide the rule of decision in each case. By applying the common law in these cases, the courts will be providing the parties with a "bargained for" regulatory scheme that will greatly and immediately enhance the overall efficiency of the derivatives markets.

One of these elements I refer to as "information asymmetry." I think Denis Foster put a finer point on it by saying that one party knows a whole lot more about the transaction than the other guy, and that is known as "superior knowledge." The other common element in these kinds of derivative loss cases is known as "event risk." My clients refer to these elements, event risk and information asymmetry, as, "Oh my God, I didn't expect *that* to happen." That, is event risk; or "Oh my God, I didn't know I could wind up losing that much money." That is known as information asymmetry. Clients also have an uncanny habit of finding religion when they are staring at a $100 million derivatives loss.

Event risk, as the term is used in the derivatives or risk management context, usually refers to the risk that an occurrence will happen that falls outside of the predicted set of outcomes. You have heard of sensitivity analysis and the like. Typically, dealers perform sensitivity analysis, usually internally, very rarely shared with the end-user, based upon a two-standard-deviation movement around the mean. Therefore, bankers analyze the range of values in only 95 percent of the possible outcomes. Now, for those of you who are still in law school here—I don't know how many of you that might be—this is the bell curve, and two standard deviations describes the area that is covered by 95 percent of the curve.

The problem is that, by using a two-standard-deviation analysis, a dealer may think that the worst-case scenario is described in a situation that is likely to happen only nineteen out of twenty times. What the two-standard deviation analysis does not do is tell you how bad things get in that one in twenty chance that falls outside of two standard deviations. One may say, "Well, one standard deviation, or 50 percent of the outcomes, you've got a $1 million loss, and two standard deviations, 95 percent of the predicted outcomes, it is a $5 million loss."

But what happens in the situation outside of two standard deviations? Is it a $8 million loss? Is it a $15 million loss? Is it a $100 million loss? Is it a $200 million loss? The model does not tell you that. This is known as the "long-tail" or "short-tail" problem, and I will spare you the details on that.

But event risk—such as the Mexican devaluation of the peso or the Thai government's abandonment of the baht basket regime in 1997—is responsible for billions of dollars of losses in the derivatives market.

Now, it is my legal view, and it is the purpose of my discussion here, that these common elements, event risk and information asymmetry, have their analogue in the common law. Event risk finds its common law counterpart in the doctrine of frustration of purpose or commercial impracticability. That is, I think, a cause of action that no one has talked about yet today.

Under this theory, commercial impracticability or frustration of purpose, an obligor is discharged from his duty to perform a contract where the failure of a basic assumption of the parties produces a grave failure of the equivalence of value of the exchange to the parties. Basically, both parties assumed something was going to happen or something was not going to happen, and then something else happened instead.

The best application of this doctrine in a setting analogous to certain types of OTC derivative transactions is a case called *Alcoa* *v. Essex Group.*[1] In *Alcoa* the parties entered into a contract whereby Essex would supply Alcoa with alumina, which Alcoa would convert by a smelting process into molten aluminum and send it back to Essex for further processing. The price provisions of the contract contained a complex escalation formula that varied depending on the Wholesale Price Index of Industrial Commodities, what was called WPI. Alcoa wanted to use the formula in order to achieve a stable net income of about four cents a pound for converted aluminum. Essex sought to assure itself a long-term supply of aluminum at a favorable price.

The contract was really very similar to a swap transaction that might be done today. The contract was to run from 1967 to 1983. Unfortunately, in 1973 OPEC oil prices skyrocketed as a result of the embargo, causing electric costs to increase dramatically. Electricity, as many of you know, is heavily consumed in the manufacture of aluminum. As a result, Alcoa's electric costs rose much higher than the WPI, such that Alcoa was losing buckets of money on its contract with Essex.

The court found that both parties had intended and expected that the WPI as employed in the contract formula would operate as it had historically done to achieve the essential purpose of the contract, which was stable cost/price adjustments throughout the term of the deal. When the WPI ceased to work in that fashion, the purpose of the contract was frustrated, and Alcoa was discharged completely from the obligations under the contract. This outcome resulted despite the fact that any fifth grader knowledgeable in long division could see from the WPI formula itself that just such an outcome was possible. It is just math. You can plug a large number for one of the variables in the formula and you could see that, under certain circumstances, somebody would get walloped.

Now, the facts in *Alcoa* are even better than in your typical derivatives debacle case. Alcoa was the party that came up with the WPI formula, not Essex. And Alcoa, obviously sophisticated in the world of aluminum costs and pricing, came up with the formula with the aid of what the court referred to as "the eminent economist Alan Greenspan." Yes, believe it or not, Alan

1. 499 F. Supp. 53 (W.D. Pa. 1980).

Greenspan came up with the formula for Alcoa. Even though it was Alcoa's formula, devised for Alcoa by Alan Greenspan, the court let Alcoa, a sophisticated counterparty, off the hook completely by applying the doctrine of frustration of purpose.

JUDGE HELLERSTEIN: Where was Alcoa's central place of business?

MR. LOVI: Pennsylvania. However, Your Honor, this is a universally and well-regarded concept of contract law.

JUDGE HELLERSTEIN: Where in Pennsylvania, the Eastern District or the Western District?

MR. LOVI: The Western District. The logic of this opinion however, comes screaming through with the utmost clarity. It is important to note that the sophistication of the parties is of no relevance in applying the common law doctrine of frustration of purpose. It does not matter that two sophisticated parties agreed to a contract that eventually goes badly for one of those parties. It does not matter that you were sophisticated or could do the math—it doesn't matter.

So we have talked about and you heard earlier, the problem of sophisticated counter-parties and whether a foreign bank is sophisticated. That problem should not be one that comes into play with this cause of action.

Now, the common law doctrine can and ought to be applied in derivatives cases where there has occurred what I have called event risk. For example, in early 1997, a number of Korean financial institutions entered into certain derivative transactions with J.P. Morgan that were supposed to provide the Korean parties what was called "synthetic low-cost yen financing." Believe me, just take my word, that is what it was called.

The yen financing aspect of the deal was expressed as a non-deliverable yen forward. In effect, the Koreans were shorting yen. In order to hedge against possible yen appreciation, the deals also included a long Thai baht forward position leveraged five times because it was understood by the parties—that is, both parties, Morgan and the Koreans—that in these transactions the offsetting forwards would work as a hedge because the baht was a managed currency and had been so for fifteen years.

Now, it is obvious from the transaction formula that if the baht ceased to be a managed currency, the baht forward leg of the transaction would not operate as a hedge. In fact, the baht leg of the transaction would start generating huge losses for the Korean parties, the exact opposite of a hedge.

The Koreans began suffering horrendous losses when the baht basket regime collapsed on July 2, 1997. You can see that the abandonment of the baht basket regime in the Morgan deals, frustrating the purpose of the baht forward as a yen hedge, is precisely analogous to the OPEC oil embargo in the Alcoa deal, frustrating the purpose of the WPI formula as a cost/price adjustment mechanism in the sale of aluminum.

The key issue in both cases is: what was the understood expectation of the parties underlying the purpose of the deal? Now, in the Morgan-created derivatives case, the court needs to decide whether the Korean counter-parties and Morgan understood that the baht forward was to be a hedge against yen appreciation; or, conversely, were the Koreans knowingly taking a naked gamble on whether the baht basket regime would remain in place for the one-year term of the deal? I mean, you could do a deal like that. It's called gambling. You might as well bet on whether Darryl Strawberry is going to get a year's suspension or a month's suspension. That would be gambling. But if you say, "Well, it is a baht and a yen, we'll do this and we'll do that," it looks like an OTC derivatives transaction.

Said another way, were the Korean counter-parties buying a limited up-side of approximately a 9 percent rate of return and selling unlimited down-side risk? If the legal issue is presented this way, the question left to be answered is one of fact for the jury to decide. But the effect on the derivatives market of framing the legal issue this way, however, would be immediate and striking. I propose that no self-respecting investment bank will take a $100-million-plus gamble on a jury of its peers. That case would settle quickly.

The broader derivatives market, however, will respond in a rational and efficient manner to eliminate this litigation risk. And this is how they will do it. Remember one of the principal purposes of derivatives is to limit risk or better manage it. I would expect that all future OTC derivative transactions will clearly state on the face of the contracts the intention of the parties with respect to all risks inherent in the transaction, thereby avoiding an Alcoa-type fact issue for litigation. With a clear statement of risk intention included in derivative contracts, the derivative markets achieve greater risk disclosure and deal transparency, without the need for a cumbersome regulatory scheme, such as the SEC or the CFTC.

The beauty of the common law is that, in itself, it is a regulatory scheme governing contracts, one that, if properly applied, can achieve in an efficient way all the goals of a more cumbersome statute-based regulatory scheme.

I've got lots of other remarks, but I am going to cede the floor to the honorable justices. Thanks very much.

A VIEW FROM THE JUDICIARY

PROF. FELSENFELD: It is no longer a secret to anybody here that we have two distinguished judges from our local courts, Judge Alvin Hellerstein from the U.S. District Court and Justice Charles Ramos from the New York State Supreme Court. Judge Hellerstein, after some thirty-six or -seven years with Stroock & Stroock & Lavan, joined the court in 1998. Justice Ramos, having graduated from this law school, joined the court in 1988. They have both done much too much for me to tell you, other than to summarize for both of them that they are distinguished and respected members of the local community both on and off the bench.

Our plan was to have a number of lawyers speak on various litigation issues and then have the two judges come up here and comment on the presentations. I have a feeling that the plan has absolutely fallen apart. Let me invite both Judge Hellerstein and Justice Ramos to come up here and spend a few minutes talking about whatever they want to talk about.

JUSTICE RAMOS:* Alvin, I think the only advice we can give the end-users is to make motions for changes of venue.

JUDGE HELLERSTEIN:** I have a chief judge who is concerned that our dockets are decreasing relative to the number of newly appointed judges. He would like us to work harder, so he would veto what you are suggesting. He is against arbitration; he is against alternative dispute resolution. He is for judges working hard.

JUSTICE RAMOS: I'll send you some cases.

JUDGE HELLERSTEIN: Well, you don't have that power, you know. I do. It is called limited jurisdiction, motions to remand. I just sent one back to your court yesterday.

JUSTICE RAMOS: Yes. We call it leftovers.

JUDGE HELLERSTEIN: I love listening to John Lovi because it is an example of some of the better part of my job. When Fritz Schwartz and John go off against each other on this

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* Justice, New York State Supreme Court

** Federal Judge, Southern District, New York.

wonderful derivatives case, which manages to come into my court about once every week and a half, it is a pleasure to see them and to argue with them and to decide. You know, it is the ultimate power. If you are not getting paid, you should have power.

JUSTICE RAMOS: We are not getting paid? Or was that unsaid but understood?

JUDGE HELLERSTEIN: Yes. Justice Ramos and I had lunch yesterday and we were talking about what we would say to you. I think we have seen a lot of specialists here who really know their field very well, and we have been asked to come and make intelligent comments to a panel where we know an infinite fraction of what they know. And actually, that is really one of the points we wanted to make to you.

As judges, we are generalists. We don't know much about derivatives. It's hard enough to know what securities are. We know the law of contracts, the law of torts; we know big papers when we see them, and derivatives mean big papers.

JUSTICE RAMOS: Big complaints.

JUDGE HELLERSTEIN: One of the points we want to make to you is that if you have a litigation with derivatives, you have to pay attention to whom you are writing for. Are you writing for your client, or for newspaper publicity, or are you writing for the judge?

A complaint is a very important document. It is a document that resides with the judge throughout the case. At every flash point in the case, the judge will want to consult the complaint to see what is alleged, to see what is in issue, to test the theory. If you have an eighty-five-page complaint, it is very difficult to do that, and the tendency then is not to read the complaint, but rather to rely on your law clerk's summary, or your own recollection, which is even worse.

The first point that I thought I would like to make is to write the complaint not for the client, but for the judge, to state your theories properly, to give the judge an understanding of what is involved, but to avoid the expletives and the rhetoric. Just boil it down. If you can do it in twenty pages or less—and I think you can—it becomes a much more useful document and, therefore, a document that better serves your client's interests. That is my first point.

JUSTICE RAMOS: I have noticed recently in the complaints that complaint number one is three causes of action long, then the next action comes along and it's those three causes of action plus two more that are added to it, and so on and so forth. It does not add anything to the case. Either the case is a good case or it is not.

What do I want to say as an overview? I guess we can't apologize for being New York judges or New York lawyers. The venue problem is an interesting one, but most of the contracts I see in the Commercial Division specify not only that New York law applies, but that jurisdiction is in either the Southern District or the Commercial Division. In fact, many parties now are putting Commercial Division and Southern District in their contracts almost exclusively. It used to be London sometimes on derivatives and securities transactions of this sort, but now it tends to be New York.

We look at cases, not as cases, but as individual issues within the cases. I do not think you are going to see a separate law of real and apparent authority develop out of a line of cases on derivatives. It is going to be the law of real or apparent authority.

The only thing that derivative litigation, to me, has of a compelling nature is that the losses are generally tremendous. Judge Hellerstein and I were kind of joking about the reference to the *Alcoa* case and where they are headquartered and where did that case come from. But when there is going to be a catastrophic loss either to a national industry or to a local industry, yes, you might find that the judges get creative as well and carve out some exceptions. But, by and large, it is difficult to see how in this area, unless you have something like the problem we had in 1998, where anything is going to be done, at least on the judicial level. I mean, there you had a bailout of a hedge fund essentially by the financial community.

JUDGE HELLERSTEIN: Not by the court.

JUSTICE RAMOS: That's right. It is conceivable, but I don't think it is going to happen, at least not in New York. We are not that parochial. So I think you are going to find that the general principles of law are going to apply.

I said to Alvin as we were just sitting here, that it is amazing how creative lawyers can get when the loss is $100 million, when you know that the same rules apply—that's out of Contracts 101—

whether it is a multimillion-dollar plaintiff or someone in small claims court. The law is the law, and it is not going to change just because the losses are great, notwithstanding the courts in Pennsylvania or Texas.

JUDGE HELLERSTEIN: Going back to this issue of authority, the disparity of knowledge point that several speakers have made—what do you call it, John?

MR. LOVI: Information asymmetry.

JUDGE HELLERSTEIN: Information asymmetry. That's wonderful. That creates attention that I think will create at least some marginal sympathy on the part of the judge. But I agree with Justice Ramos that in the final analysis, where you have a jurisdiction like New York which has developed law on more subjects than most other jurisdictions, it is going to be very hard to translate that sympathy into a ruling.

We look to do justice, but we also look to see where we are going to be affirmed and where we are going to be reversed. If you push your theories because you are sympathetic to a particular theory, then you risk reversal. I do not think we are very much interested in doing that on a case where the law is there.

For example, in much of the derivatives litigation—it was in the Orange County case, which I am more comfortable talking about because I don't have to sit in judgement on that—the argument was made that you had a treasurer of a county who was looking for his own agenda to dress up his financial statements at a time when it was very difficult to earn income.

There was terrible pressure in Orange County. To translate it, the County had needs. It did not want to tax. They had various propositions in California that limited the ability to tax. So there was tremendous pressure to gain as much income as possible out of the securities that the treasury held. You couldn't get much income out of the government securities that the treasury held because of the low interest rate at that time. So there was pressure to do more with it—hence, leverage. Securities, derivatives, all these things, are games of leverage. By indulging in these games, for awhile he was able to boost the income return to the County.

But the concomitant of additional income is additional risk, and he was willing to take on additional risk. The one chance in twenty that John talks about in terms of the bell curve is often a tolerable risk to a politician because that one chance in twenty may come when the next guy is in office and he is out and he has a good record. But the payday comes and then there is difficulty.

The difficulty of using doctrines like *ultra vires* or lack of authority, even if the fellow who is making these investment decisions, for example, is a country bank, is not very sophisticated and the seller is sophisticated, is you run up against doctrines that are well pronounced in New York. For example, as someone said earlier, the contract in its four corners defines the risks and rewards, defines the differences in rights and liabilities. Or, if someone sets up a person with authority, that person has apparent authority to act. You are not going to find too many judges in New York who will change those doctrines because of a particular derivatives case.

JUSTICE RAMOS: I suppose both of us do have to apologize. There are a lot of specific issues that we really cannot opine on here because we have cases before us and we are somewhat restrained in terms of what we can say, unlike the attorneys. I think we could say we have never been as well ex-parte'ed for as long a period of time as we have been this afternoon. We heard a lot from end-users. There is an interesting story also to be told from the point of view of the producers. We understand that, we do.

JUDGE HELLERSTEIN: I think we had some producer interest as well.

Here is another couple of points that we wanted to talk about. These cases rarely, as someone else said today, get to judgment. Because the aggregate numbers are so huge, at some point along the way there will be a discount, which will be called a settlement. People will go home, and that will liquidate the various risks and rewards that have been taken on by the parties and the debacle that has been suffered by one or another of the parties.

So the game is getting there. You start with a complaint that is filed, and then you are going to have various motion practices. You are going to test the complaint and knock off some of the theories, just as was done with Judge Sweet's case. And you will also engage in discovery. Discovery presents some very difficult problems, especially in a state court setting, but even in a federal court setting.

In a case that John had, in which he settled with Fritz Schwartz of Cravath and many other parties, there were very difficult depositions that had to be taken. They were difficult not because of the questions and answers, but difficult because many of the protagonists in the parties had moved on and they were not very much interested in coming to a discovery. If you ask any non-American what he or she hates most about our system, it is our discovery; and what any American lawyer loves the most, it is discovery. So you have a difficulty in getting to depositions.

Key witnesses no longer were with the parties, or were said to be no longer with the parties. With the profusion of entities that are involved in these kinds of cases, you never know who is the party and who is not the party. You have special-purpose entities, you have affiliates, you have minority control—you have all these kinds of things making it very difficult to know who was under the custody and control of the party.

You try to get the witness to come to the States. He makes an appointment, then he's got a pressing business engagement, then he does something else, and so on. He never shows up. So the judge will say, "Okay, take the deposition in the country of residence"—Hong Kong, Korea, Japan, Thailand, Malaysia, wherever.

Then you run into some very acute systems and problems. Except for the Commonwealth countries, almost every other country in the world is on the French system or the German system; a civil code. Depositions are taken by a magistrate judge. There is no verbatim transcript. The judge will ask the questions. Between the time of making the request in a letter rogatory from the State Department to the Ministry of Justice in some other country and the appointment of a judge to convene the deposition and interrogate the witness, many months can elapse. And then the magistrate will ask the questions; you are not permitted to ask a single question. In some countries, if you take a clandestine deposition voluntarily, you are violating the law and can go to jail—civilized countries, Switzerland and France, for example—creating special difficulties with discovery and requiring a very attentive judge.

Another issue is that, since the amounts are huge, lawyers work, and when lawyers work they start to fight, and when lawyers fight the fighting gets more and more acrimonious, and the professionalism with which everyone begins the case soon evaporates. We were talking about this at lunch, too, and we both have special procedures that result in getting you quick and responsive rulings—maybe not right, but responsive.

JUSTICE RAMOS: The term draconian comes to mind.

JUDGE HELLERSTEIN: Not from my end. It may be for the end-users. But we try to give you prompt rulings. Our experience is that when you have a ruling, the lawyers will abide by the ruling and they will not fight about that particular point anymore, and I think it helps to enhance professionalism. That is another end of it.

But discovery is very difficult in these kinds of cases, and probably it justifies coming to court rather than doing arbitration. A lot of arbitration clauses creep into the contracts because commercial people do not like litigation, they do not like juries, and they want arbitration. They will pick London or pick Geneva. They pick nice places usually, London in the theater season, Geneva in the springtime, and go back and forth. Maybe Aspen is another site. But you cannot get good discovery out of arbitration, and I think, as any lawyer who has been involved in these cases knows, the discovery process is crucial.

JUSTICE RAMOS: Alvin, during lunch I was trying to cut down our caseload, so I was talking to some attorneys who were with American Express and Chase Manhattan and encouraging them to put arbitration clauses in these contracts. No, they don't want to do it because arbitration is becoming as expensive as litigation, because now you are getting discovery in arbitration, the arbitrations are being held in expensive locales, and they are resisting it, which is somewhat frustrating.

JUDGE HELLERSTEIN: And many of the arbitrators are amateurs. We are professionals. We get reviewed.

JUSTICE RAMOS: We are professional amateurs. You know, "I am an expert in derivatives; I had a couple of cases."

JUDGE HELLERSTEIN: We have to write opinions, we get reviewed, we get reversed.

JUSTICE RAMOS: That is true. They have appellate rights.

Interestingly, we did not discuss the problems of my particular case, the *SEITA* case, in terms of the discovery that went on there, but, as Ms. Jackson knows, we had exactly all of these problems in getting the testimony of the key witness in the case. Thank God we didn't have to try the case. You heard Ms. Jackson explaining some of the complexity with regard to the swap transactions that were involved in the Salomon Brothers/SEITA deal. Can you imagine trying that before a jury? I think their hearts would stop. I mean, there is no way they are going to follow that. It was kind of fun to watch Frank Barron trying to explain it to me.

It is very difficult for litigators to be as expert as Ms. Jackson is in terms of how these transactions work. This may be a good thing, because I think simplifying the dispute helps the judges—not just because we have small minds, but because, again, we are going to look at those issues and those principles that are common to all kinds of litigation.

Are the elements of fraud present? I cannot imagine a derivative action being brought without at least one cause of action alleging fraud, another one alleging some sort of constructive fraud, a negligent misrepresentation, a failure to disclose, a breach of fiduciary duty—they are all there. But these are not surprising concepts to us, and if you can simplify them, and if you can get away from some of the complication of the transactions themselves, you might be effective.

Understand, at least from the end-user's point of view, the playing field is not a level one. I know there are some small players in this field, but, by and large, the end-users are going to be large, they are going to be sophisticated, they are going to have done this before. This was true in my case; the end-user had already paid $30 million and had written off the loss, and then the new management came along and basically said, "Wait a minute, let's rethink this." They changed their minds.

It is a difficult, difficult case to win from a plaintiff's perspective, at least in a court that is going to give everybody a fair shot, because the principles of law—think of the things that do not apply. If you are just dealing with OTC products, you do not have any real regulation, it is contract only. It is not like a public offering; rather, it is like a private placement, and due care is placed on the plaintiffs—that is the plaintiff's responsibility.

PARTICIPANT: It is *caveat emptor.*

JUSTICE RAMOS: Pretty much. And it is easy from a plaintiff's position to talk about the greed of the brokers, but, quite frankly, the only reason these end-users are in the transaction is because they are greedy. They don't want to get 6 percent on a Treasury bond, or whatever the rate is today. I don't know what is going on.

JUDGE HELLERSTEIN: Well, that puts an epithet where it may or may not be applicable.

One point I was interested in on the analogy of the case that John Lovi cited from the Western District of Pennsylvania is, why aren't these cases brought under different systems of laws? For example, are Korean Life and Morgan both amenable to the jurisdiction of the courts in the Republic of Korea? Was that an option?

JUSTICE RAMOS: There is litigation going on.

MR. LOVI: Well, Your Honor, without disclosing any attorney-client communication or attorney work-product or strategy of any pending matter, I can answer hypothetically that, one can imagine that Korean Life Insurance, which is now taken over and operated by the Government of Korea, that the Government of Korea could pick up the phone and order Morgan to pay them back the $100 million or threaten to throw them out of the country. But I think that would jeopardize Korea in the capital markets, which they need to access going forward. But if they go to Morgan's hometown and get justice there and win, who can say that the Government of Korea used undue force?

JUSTICE RAMOS: The bottom line is they need us more than we need them.

JUDGE HELLERSTEIN: I could think of some ideas. The American system of justice is perhaps more advanced than in some of the third-world countries, or there is more experience in dealing with large commercial cases, or this idea of greater acceptability and fewer political pressures on the government. I do not know. But there was litigation in the earlier case you had in Korea, as I understood.

MR. LOVI: There was litigation in both Korea and in the United States in the case that was settled.

JUDGE HELLERSTEIN: What was happening in Korea at the same time?

MR. LOVI: They have a totally different system. There is no discovery. They go to the court every month or so and give the judge more information. Then the judge at some point says, "I've heard enough, I think I know the answer"—you never know when that is—and then he gives a ruling.

JUDGE HELLERSTEIN: So are we moving faster than they?

MR. LOVI: Yes. That may have been totally stalled as a result of the operation of the system as opposed to the parties participating in the system.

JUDGE HELLERSTEIN: It is very difficult. My experience as a litigator was that our system was a system that was better for litigants, better for consumers. The transaction costs, though very heavy, were less, and the ability to get discovery was greater.

JUSTICE RAMOS: But to give up home field advantage? That is a political step, it has to be. It has to be a political determination that "we are not going to sue Morgan in Korea because we want Morgan and the Morgans of the world to come to Korea and fund what we need funded, so we will play in London or in New York."

JUDGE HELLERSTEIN: It's interesting.

Do people in the audience want to ask questions?

JUSTICE RAMOS: Please. We are here to inform you.

QUESTION: I want to jump in to say that, in some sense, the U.S. judicial system is an asset that we sell. I was involved in a transaction between a Hong Kong entity and a Taiwan entity. They went shopping for a U.S. intermediary because they wanted, if there was a dispute, to have it resolved by the New York courts, in particular, rather than have to rely either on the Chinese courts or the Taiwanese courts, or even other financial centers they could have picked.

MR. LOVI: Aren't the Chinese courts and the Taiwanese courts the same court now?

QUESTIONER: In some sense, it is one of our exports, like Delaware Chancery is for the State of Delaware and the courts on which the two of you sit. I don't think many Americans value our legal system that way, as a national export.

JUDGE HELLERSTEIN: In my court that would not be an option because a lawsuit between a citizen of one foreign state and another foreign state does not create diversity of citizenship.

JUSTICE RAMOS: Are you going to move *sua sponte* to send the case to me?

JUDGE HELLERSTEIN: Nothing would give me more pleasure.

JUSTICE RAMOS: In fact, I had a case that was just resolved recently between two Russian banks suing one another. That was it. They agreed to come to the Commercial Division in New York County, and we will take it.

JUDGE HELLERSTEIN: I think it is a stated policy of New York State to provide that.

JUSTICE RAMOS: It is.

JUDGE HELLERSTEIN: Judge Kaye, who I think is perhaps the finest Chief Judge in recent history, has set up this Commercial Court in which Justice Ramos is one of the leading participants precisely to give a better brand of justice, to compete with the federal courts, and to attract people to the judicial system.

JUSTICE RAMOS: For those of you who are not aware, I will give you a little unpaid advertisement. The Commercial Division consists of five judges in Manhattan and we work only on commercial cases of substance. Each of us has the right to transfer out to other justices cases that we do not consider to be important enough, so that we basically vet our own cases. We keep a case load of about 450 cases, and they are interesting. They are good cases, they are interesting cases, they are well litigated, they have wonderful attorneys, most of whom are here. It is a delight to sit in the Commercial Division.

JUDGE HELLERSTEIN: The comparison in the Federal Court is that my civil docket is about 300 cases, my criminal docket is about eighty/eighty-five cases, which turn over more quickly, so you would weight them in a higher number. The diversity of the civil cases is probably wider than for the Commercial judge.

JUSTICE RAMOS: Oh, yes.

JUDGE HELLERSTEIN: A lot of employment discrimination cases, a lot of pro se cases, a lot of cases involving constitutional liberties, and the gamut, in addition to very complicated statutory cases. But I think we each feel extraordinarily privileged to be able to sit in our courts. It is really a wonderful experience.

QUESTION: How far does the concept of *caveat emptor* go? What if the dealer knew for certain that the customers did not understand the derivatives that were being sold? What if the dealer was lying—not giving a mis-estimate, but lying about the facts?

JUDGE HELLERSTEIN: I am not going to answer your hypothetical because I have cases that deal with that sort of thing. That is point number one. Point number two, the question really should be put to Charlie, because I only apply New York law. He is more expert on New York law.

JUSTICE RAMOS: That's the good news. The bad news is that I made it and the Appellate Division agreed with it.

Well, if we look at the *SEITA* case, there the end-user was alleging that they didn't have proper information and that they were unable to value the swaps accurately and, therefore, they were short-changed. So, first, they wanted out of the deal; and second, they just wanted to recover some of the money. You have a big reliance problem. That is the difficulty SEITA had. I ruled, and the Appellate Division ruled, that there simply wasn't reasonable reliance. They had the capability, a means, of getting this information themselves. Now, that is not necessarily going to be true of every end-user, but we made that factual finding with regard to SEITA.

JUDGE HELLERSTEIN: The law to be applied is rather interesting also. Short of a choice of law clause in the contract, what law do we apply? If it is a deal that is made in an emerging country, what are the contacts in that country? And, is the product bundled in the United States and sent abroad, in a sense? Where is the collateral? What is the risk? All these things come into play.

So what law do you apply? And, even if you have a choice of law in the contract, when you raise issues of fraud and other tort theories, the choice of law clause may be background information, but may not be dispositive of the issue.

So what do you apply? There is no federal common law that deals with this sort of thing. There are various types of notions that you apply a sort of generalized American law. I have a case in the insurance setting where I am instructed to apply "the customs and practices of the United States," as compared to the London insurance market. There is an insurance market in the United States, there is an insurance market in Kansas City, there is an insurance market in New York. Insurance is supposed to be a local product rather than a national product.

These things are very interesting, and there is no good teaching on this particular point. Often, lawyers do not brief the issue because they also do not know what they want in this situation. It is too complicated, so the judge applies the law with which the judge is familiar, New York. But it is interesting.

MR. LOVI: On some issues we have to go with the common law rule of the system.

JUDGE HELLERSTEIN: Whatever that is. What is the common law in Korea, for example? There is a law merchant. There is sort of a brooding international law merchant. That used to be a lot more important in the 19th century than now. You can dig that out of maritime cases, Warsaw Convention cases, and other kinds of things like that, but it doesn't take you very far.

That issue tends to get suppressed because who wants to go find what the law of Taiwan is on a particular point, or the law of Malaysia? Many of these countries have a history of being in existence only forty to fifty years, so there is not much time to develop law. And then, not too many of us know how to read Chinese ideograms either, or ideographs, whatever they are called. Professor Felsenfeld probably knows about that.

JUSTICE RAMOS: Yes?

QUESTION: I just wondered if you had any practical suggestions on how to present a complicated case of this type to a jury?

JUSTICE RAMOS: Oh, my God. Don't. Waive the jury.

JUDGE HELLERSTEIN: I do not agree with that. I have never tried a derivative case either from a lawyer's part or a judge's part, but I have tried complicated cases. John gave a presentation, David gave a presentation, others gave presentations. There were a good many of them. They were well presented. They could be followed. I think that most of us who practice before juries feel that juries will rise, not to the lowest common denominator, but to a rather high common denominator. You have to make a special effort to present them with diagrams and charts and the like, to boil down the proofs so that they are just the essential proofs, and to be able to communicate in an effective way.

You tell your spouses about these cases, and often your spouses are not lawyers. You tell your friends; they are not lawyers. Even if they are, they are not interested, so you've got to boil it down. I think you can do it.

JUSTICE RAMOS: It just would be interesting to see if you could get to a jury in one of these cases, at least in New York. When I think in terms of what can happen with dispositive motions —I mean, after you have gone through the kind of discovery that you all do with these sorts of cases, there is not a great deal that is really actually in dispute. In *SEITA* we really didn't have that many factual disputes. It was more legal. The attorneys could present to me very, very finite and nicely defined issues and I could rule as a matter of law. It takes perhaps a couple of years of discovery to get there.

If it boils down to a true factual issue of what was told to an end-user by a broker and there wasn't a tape, that would be an unusual case. Then, of course, you are going to go to a jury. But then it is a simple issue for the jury. The jury does not have to figure out how to value the swap. The jury—or the judge even—can listen to expert testimony on that and you can agree on what the damages will be. If the jury finds this way on a particular issue, the consequences will be so much—we know what it is, because it is just an arithmetic computation.

JUDGE HELLERSTEIN: The New York rules are more liberal towards summary judgment than the Federal Rules.

JUSTICE RAMOS: Oh, yes.

JUDGE HELLERSTEIN: The trial judge will be upheld more often on summary judgment calls in the state system than in the federal system. The rules are pretty much the same.

JUSTICE RAMOS: Because we have interlocutory appeals, so there is a kind of a check and balance there. And, the Appellate Division is not reluctant to affirm us, to dismiss a case, if we have really touched all the high points and given them something clear on it. They will either tell us we are right or wrong, but it is clear.

Dispositive motions also will simplify a case. Judge Hellerstein was talking about that, and I really applaud that. Sometimes we get these complaints with dozens of causes of action, most of which are just garbage. And we are offended by it, because we should not have to parse out what is reasonable in a complaint. And it is always a good idea to make those preliminary motions either at the dismissal stage, or even summary judgment, and get rid of the nonsense, so at least we can deal with what is really important.

QUESTION [PROF. RECHTSCHAFFEN]: One of the things that we talked about in my class, and I was talking about this with Denis Forster during the break, is in terms of this complexity issue. What has been done generally is to allow the experts to be as complex as possible, making the transaction as complex as he can, but making the legal issues very simple.

JUDGE HELLERSTEIN: I don't really agree with that. The real purpose of an expert is to have a mini-summary in the middle of the case. If you think about a jury case and what you are using an expert for, you want the expert to persuade the jury. The experts give opinions, and the opinions have to be credible and persuasive, so you want the jury to be able to understand the expert. Therefore, if you are trying to win a case as a plaintiff, it is critical that the expert be able to communicate in a way that the jury understands.

JUSTICE RAMOS: But what if the expert wants to convince the jury that no one could understand the transaction?

QUESTIONER [PROF. RECHTSCHAFFEN]: That is the point I was making, from a strategy point of view.

JUDGE HELLERSTEIN: I think a cross-examiner can break that expert.

JUSTICE RAMOS: Which is why I always require expert depositions. State law does not provide for it, but I insist on it, because that is the only way you are going to get to the heart of the matter fairly quickly, is to have them deposed.

JUDGE HELLERSTEIN: And also, you have the opposing expert. I think the analyses that we are making of risks and risk management really come down to the proposition that people are looking to make a buck in different ways. The best use of your expert is to: 1) analyze the structure to see where the buck is made, 2) analyze the risks as foreseeable or unforeseeable, or 3) analyze the risks as contemplated by the parties or not contemplated by the parties. Thereby you structure your factual presentation in terms of what the legal presentation would be.

Those of us who have been around a lot and listened to Irving Younger, whose untimely death was a real blow to the whole profession and academia, remember him saying one thing: when you structure a case you begin your preparations with what you want to leave with the jury at the end of the case. You structure your whole case—and derivatives cases are no different from any other case—based on what you want the jury to remember when it is time to deliberate. Everything starts to arrange itself in that way. You know what you want to leave the jury at the end and you structure your case, and, most of all, your experts, to state a theme that is going to resonate from the beginning to the end. That's how you do it.

JUSTICE RAMOS: Just a thought about complexity. The motivations for an end-user getting involved in a derivative transaction can be as complicated as the transaction itself. That is something that I don't think is touched upon a great deal, but in terms of the defense perspective, particularly when you are dealing with sophisticated end-users, it can be a very interesting area.

JUDGE HELLERSTEIN: Every one of these cases had end-users who were trying to make a little more. In a very difficult market, they were trying to make a little more.

ATTENDEE: And they were successful for some time.

JUDGE HELLERSTEIN: Yes.

QUESTION: Judge Hellerstein, this is really directed towards you on the question of *caveat emptor.* A lot of these cases are brought under the federal securities laws, either under suitability claims, or they could be brought as straightforward 10b-5-type claims.

JUDGE HELLERSTEIN: Is this where there is an actual security that is purchased, as opposed to a product?

QUESTIONER; Yes, or an option, an option to purchase a bond.

JUDGE HELLERSTEIN: A derivative is a security, I think.

QUESTIONER: Yes. A put or a call can be a security, and often is.

JUDGE HELLERSTEIN: As opposed to an OTC derivative.

QUESTIONER: It could be an OTC put or a call.

JUDGE HELLERSTEIN: It wouldn't make any difference for this purpose. For 10b-5 purposes it would not make a difference.

JUSTICE RAMOS: It would still be covered.

JUDGE HELLERSTEIN: It is either a contract or a security.

But, of course, the question is which. I don't want to be put down as saying I believe in *caveat emptor*. Much depends on the total relationship of the parties. The question I put earlier, in terms of how a seller can become, in effect, part of the buyer, has to be thought about in terms of a *caveat emptor* standard. Obviously, *caveat emptor* will not apply in that kind of context. But in the securities context, you also have a change. Securities laws helps you get around the very difficult issue in fraud cases: is there a relationship that requires a disclosure on the part of the seller to the buyer? A seller, if he keeps his mouth shut, can sell a mule instead of a horse and leave it to the buyer to distinguish between the two. A seller of securities has a more difficult problem, but even under the securities laws, if the seller keeps his mouth shut, he does not have to say anything and it is *caveat emptor*.

The problem comes up because most sellers do not keep their mouths shut. They say something, and once you say something, you have the law of nondisclosure, namely, that the thing you say is incomplete and fraudulent because of your failure to say something else. So the law of nondisclosure deals with that which has to be said in order to make that which you said not fraudulent.

The law is quite helpful in the 10b-5 context and I think it is a viable alternative. However, there has been an effort by many plaintiffs to stay away from federal securities laws because of the special restrictions that have been built in, not so much on a party-to-party basis, but on a class action basis.

QUESTION: I have a question about enforcement of foreign law by way of not enforcing a derivative contract. It was suggested earlier that U.S. counter-parties make an effort to do some due diligence as to the enforceability of a transaction under local law. How would you do that under varying hypotheticals—whether there was awareness of the problem of global law, there is no awareness, that the local party was aware, those kind of issues—because that would be a serious transactional problem to do that kind of due diligence?

JUSTICE RAMOS: I think one of the earlier speakers spoke about the problem of what happens if this transaction takes place in part within the foreign jurisdiction. Then you may have a problem of foreign law. Then you've got choice of law issues.

JUDGE HELLERSTEIN: Orange County—Merrill Lynch and other dealers in New York were selling securities in a complicated repo way to Orange County. Like many counties, like many banks, there is a requirement in California written into the constitution that you cannot guarantee someone else's debts. It is in bank charters all the time, it is in many corporate charters—cannot guarantee a debt. A pledge used in effect as the instrument by which one is induced to borrow or lend or do something with a more speculative security or something else is a form of guarantee. The argument was made that guarantees were, therefore, *ultra vires*, under the charter of Orange County and under the constitution of California.

JUSTICE RAMOS: Regardless of where the contracts were made, even if they were made in New York?

JUDGE HELLERSTEIN: Regardless.

JUSTICE RAMOS: Because they didn't have the authority?

JUDGE HELLERSTEIN: And, as it were, much of the litigation was in California. Now, the secret and special power of that doctrine is that it trumps apparent authority. So if it is illegal in the area of the transaction, then it is illegal. Of course, this could be perfectly legal everywhere else, and Merrill Lynch was doing nothing different than any other dealer, and it was essentially the market and the like.

This was a very powerful issue that ultimately was discounted in some fashion by the settlement. The defense lawyers thought very little of the likelihood of success, but you were outside the bell curve if in that one out of twenty or one out of fifty cases you lost, because the price of losing was your ability to stay in business. That drove the settlement.

JUSTICE RAMOS: But, Alvin, that was such a powerful issue. I just can't imagine that if you had private counterparties who didn't have an *ultra vires* problem, but just a conflict between local law and New York law with a choice of law provision in the contract that says "this contract shall be construed as if it was performed in New York," that you would get the same result.

JUDGE HELLERSTEIN: But that is one issue. That does not trump anything, because there is very little law that says that a choice of law clause will override a policy of illegality. Take the Korea Life situation.

JUSTICE RAMOS: What about gambling cases? Gambling is legal in Nevada; it is not legal here.

JUDGE HELLERSTEIN: We get around the gambling a lot because—I don't know.

JUSTICE RAMOS: We got around it. We fudged it.

JUDGE HELLERSTEIN: But it is probably the same thing, and it probably will stand up the same way that everything else does. I am sure that Korean financial institutions have the same clause having to do with guarantees, forbidding a financial institution to guarantee. If this is considered a guarantee and not a regular financial transaction, then there is an issue.

JUSTICE RAMOS: But they may not raise it because politically it would be too dangerous for them.

JUDGE HELLERSTEIN: Possibly.

JUSTICE RAMOS: They would rather lose.

JUDGE HELLERSTEIN: Or they may just look at the gambling part of it. I mean, there is a small chance, and I think every pleader will understand that it is a small chance, that this issue of illegality will create a problem in what is going on in a worldwide way. But that small chance discounted against the billions of aggregate dollars that go into these kinds of deals is worth something. I think that is what is at play here.

Someday someone is going to forget and the case will go and some judge is going to say the transaction shouldn't have been done or the transaction should have been done. It doesn't make any difference or it makes a lot of difference—I don't know. Nobody knows the answer to these kinds of things.

JUSTICE RAMOS: That is why you should settle.

JUDGE HELLERSTEIN: I mean, on one hand, you have a worldwide market, there is globalization. Globalization trumps environmental laws. Globalization trumps labor laws, so you can have someone in Malaysia working at five cents an hour to make the sneakers that I wore to play tennis last night and it is legal, even though if it were five cents an hour in this country, the employer would be thrown out of the world, he would be exiled to some place up in the universe. What is legal in a situation of globalization? Who knows?

PROF. RECHTSCHAFFEN: Judge Hellerstein, Justice Ramos, we want to thank you very much for being here.

Notes & Observations